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“Once a Mortgage, Always a Mortgage” – The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments

Andrew R. Berman*

Since the beginnings of English common law, property owners have used the mortgage as the principal instrument to finance real estate acquisitions, provide liquidity, and raise additional capital.¹ And if a first mortgage proved insufficient, the owner simply borrowed additional funds secured by a second mortgage on the same property. Although the mortgage first developed in agrarian England to finance acquisitions of farmland,² over the centuries it has proved particularly adept at satisfying the financial needs of owners with all types of real property.

To this day, the mortgage remains one of the most common and successful techniques to finance both residential and commercial real estate transactions in the United States.³ As the mortgage market continued its exponential growth over the

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¹ In his oft-quoted treatise, *COMMENTARIES ON AMERICAN LAW*, James Kent defines a mortgage as “the conveyance of an estate, by way of pledge for the security of debt, and to become void on payment of it.” 4 JAMES KENT, *COMMENTARIES ON AMERICAN LAW* 138-139 (Jon Roland, ed., O. Halstead 15th ed. 2002) (1826). As others have noted, this definition is broad enough to cover almost any form of mortgage but includes two essential elements: conveyance of land and security for a loan. LEONARD JONES, *A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY*, Ch. 1, § 16, at 21 (7th ed. 1928).

² 4 RICHARD R. POWELL, *POWELL ON REAL PROPERTY* § 37.05[1] (Michael Allan Wolf ed., Matthew Bender 2004) (1949) (describing the historical development of the mortgage as a “localized transaction in an agrarian setting”).

³ Residential mortgage financing now represents a multi-trillion dollar market with banks and other financial institutions making over \$3.75 trillion of residential mortgage loans in 2003, compared to \$1 trillion in 2000, and \$500 billion in 1995. According to the Federal Housing Finance Board, by the end of 2003, residential mortgage debt increased 40% since 2000, jumping from \$5.6 trillion in 2000 to nearly \$8 trillion in 2003. Mortgage and Market Data, 1-4 *Family Mortgage Originations 1990-2002*, available at <http://www.mortgagebankers.org/marketdata/index.cfm?STRING=http://www.mortgagebank>

last 25 years, however, a new (and soon to be powerful) real estate financing technique also emerged. This technique first involved the active trading of whole mortgage loans⁴ on the secondary mortgage market⁵ and later the securitization of large pools of mortgage loans.⁶ At first these securitizations consisted almost entirely of residential mortgage loans (Residential Mortgage Backed Securitizations or RMBS).⁷ As the industry matured, however, mortgage securitizations also soon included pools of commercial mortgage loans (Commercial Mortgage-Backed Securitizations or CMBS).⁸ Wall Street and other large-scale financial institutions underwrote these securitizations in an attempt to duplicate the success of mortgage lenders in the residential mortgage market. With their aggressive marketing and

ers.org/marketdata/mortgage.html (last visited Dec. 1, 2005); Federal Housing Finance Board ("Freddie Mac"), *U.S. Housing & Mortgage Market Outlook*, available at http://www.taxadmin.org/fta/meet/re_pres04/notaft.pdf (last visited Dec. 1, 2005).

Commercial property owners have also used traditional mortgage financing to raise capital since they often lack access to other financing sources. Steven Schwarcz, *The Alchemy of Securitization*, 1 STAN. J. L. BUS. & FIN. 133, 151-152 (1994) [hereinafter Schwarcz, *Alchemy*] (describing how many companies "do not have direct access to low cost capital market financing" because of their "relatively small size", "limited financing requirements" and because they are "generally unrated or rated less than investment grade"). Consequently, commercial mortgage financings have also grown significantly. In 2003, lenders originated almost \$200 billion of commercial mortgage loans, and the total amount of commercial mortgages outstanding at the end of 2003 was in excess of \$2.2 trillion. When residential and commercial mortgage loans are combined, the aggregate of all mortgage loans outstanding as of the end of 2003 exceeds \$9.4 trillion. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, Table F. 2 (Dec. 9, 2004), available at <http://www.federalreserve.gov/releases/z1/20041209> (last visited Dec. 1, 2005); Mortgage and Market Data, *Mortgage Loans Outstanding*, available at <http://www.mortgagebankers.org/marketdata/index.cfm?STRING=http://www.mortgagebankers.org/marketdata/mortgage.html> (last visited Dec. 1, 2005) (based on Federal Reserve Board "Flow of Funds Accounts of the United States").

⁴ A whole mortgage loan refers to the initial mortgage loan originated by a lender as compared to certificates, participations, tranches, and other similar fractional interests in a mortgage loan.

⁵ The secondary mortgage market refers to the sale by mortgagees of one or more whole mortgage loans to other financial institutions or investors, but most frequently it refers to what is referred to as mortgage securitizations—commercial mortgage-backed securitizations (CMBS) and residential mortgage-backed securitizations (RMBS).

⁶ The securitization market refers to the process in which entire pools of mortgage loans are sold typically to a securitization trust or a similar type of special purpose entity. This trust vehicle then usually sells to the public certificates or securities which are secured, and receives the cash flow generated, by the underlying pool of commercial and/or residential mortgages. See also *infra* note 13.

⁷ Residential mortgage-backed securities (RMBS) typically refer to pass-through securities that are based on cash flows from a pool of underlying residential home loans. See also *infra* note 13.

⁸ Commercial mortgage-backed securities (CMBS) typically refer to pass-through securities that are based on cash flows from a pool of underlying commercial mortgage loans. See also *infra* note 13.

sales, the outstanding amount and new issuances of both residential and commercial mortgage-backed securities grew at an astounding rate.⁹

The ascendancy of mortgage securitizations has had a profound impact on the financial markets from “Main Street” to “Wall Street,”—changing the very basics of real estate finance for first time home buyers, major financial institutions in the United States and even the global markets. The boom in mortgage securitizations has also led to the development of a vast array of new real estate financing techniques. These financing techniques, which didn’t even exist ten years ago, span a broad spectrum of intricate legal structures and theories, combine elements of both debt and equity financing, and fall at the intersection of traditional mortgage financing and the capital markets. This article focuses, in particular, on two of these new financing techniques: mezzanine loans and preferred equity investments.¹⁰

⁹ Combined issuances of CMBS and RMBS grew from (a) \$22.5 billion in 1978, WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES—PRODUCTS, ANALYSIS, TRADING 54 (New York Institute of Finance 1989) [hereinafter BARTLETT, MBS], to (b) \$1.34 trillion in 1990, Joseph Shenker & Anthony Coletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1372 (1991) [hereinafter Shenker, *Asset Securitization*], and (c) \$5.3 trillion in 2003, Letter from American Securitization Forum to the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, *Comment Letter Re: Interagency Statement On Complex Structured Finance Activities*, reprinted in NEW DEVELOPMENTS IN SECURITIZATION 2004: PREPARING FOR THE NEW REGULATORY REGIME (2004), available at 871 PLI/COMM 345, 348 (Westlaw). Some have estimated that “[s]ecuritized lending now accounts for almost 20% of all outstanding commercial and multifamily mortgages in the United States.” Joseph Forte, *Wall Street Remains a Key Player in Commercial Real Estate Financing Despite Capital Market Fluctuations*, N.Y. ST. BAR J., July-Aug. 2001, at 34, 38 [hereinafter Forte, *Wall Street Key Player*].

When traditional senior and junior mortgage financings are combined with all residential and commercial mortgage securitizations and other similar secondary mortgage market activities, the aggregate of all mortgage related financings swells to almost \$15 trillion. U.S. Census Bureau, STATISTICAL ABSTRACT OF THE UNITED STATES: 2004-2005 744 (U.S. Dept. of Commerce 2004). The securitization and secondary mortgage market not only continues to grow here, but it has increasingly become one of the most important sources of financing in the international capital markets. In 2002, the aggregate of all non-US CMBS issuances exceeded \$28.6 billion, an increase of almost \$6 billion from 2001. Mortgage Bankers Association, *Issue Paper: Secondary Market for Mortgages 2* (July 2004), available at http://www.mortgagebankers.org/library/isp/2004_7/Secondary%20Market%20for%20Commercial%20Mortgages.pdf (last visited Dec. 1, 2005); see also, Howard Esaki, *Japanese CMBS: A JPY 25 Trillion Market?*, REAL EST. FIN., Feb. 2003, at 5 (Japanese CMBS market has potential to grow to US \$200 billion or more); Georgette Poindexter and Wendy Vargas-Cartaya, *En Ruta Hacia El Desarrollo: The Emerging Secondary Mortgage Market in Latin America*, 34 GEO. WASH. INT’L L. REV. 257 (2002) (discussing the explosive growth of the secondary mortgage market in Latin America).

¹⁰ Richard D. Jones & Daniel W. Simcox, *Six Degrees of Subordination: The Different Types of Subordinated Debt in Securitized Transactions and the Developing Views with Respect to these Proliferating Forms of Loans*, COMMERCIAL SECURITIZATION FOR REAL ESTATE LAWYERS (Mar. 22, 2001), available at SF88 ALI-ABA 311 (Westlaw).

In the real estate industry a mezzanine financing refers to a loan secured principally by the borrower's equity in other entities. Unlike conventional mortgage financing where the borrower owns real estate, a mezzanine borrower doesn't directly own any real property nor does it operate any business—it acts merely as a sort of holding company. A mezzanine borrower typically only owns equity in a family of other subsidiaries, and these other subsidiaries actually own the underlying real property.¹¹ Therefore, the value of the mezzanine borrower's collateral is derived solely from its indirect ownership of the underlying real property.¹² The complicating factor, however, is that this same underlying parcel of land also typically serves as collateral for a mortgage loan between a conventional mortgage lender and the mortgage borrower—the direct owner of the property.¹³ Because of the unique structure of mezzanine financing, therefore, the mezzanine loan is always subordinate to the senior mortgage lender's collateral. At the same time, however, the mezzanine loan remains senior to the borrower's equity investment in the underlying real property.¹⁴

Unlike mezzanine financings, preferred equity transactions aren't even technically loans. Here, the lender typically makes a direct investment (generally in the form of a capital contribution) in an entity. Typically, this entity directly owns income producing real property and is also a mortgage borrower with a separate mortgage lender. In exchange for its investment, the financing source receives equity in the mortgage borrower.¹⁵ Oftentimes however, the senior mortgage prohibits or otherwise restricts a direct investment in the mortgagor. In such cases, the financing source makes an investment in a newly formed entity, and that new entity (directly

¹¹ The equity interests typically consist of membership interests in a limited liability company, sometimes stock in a corporation, and rarely limited partnership interests in a limited partnership.

¹² The term "mezzanine borrower" refers to the borrower under the mezzanine loan, and the term "mortgage borrower" refers to the separate legal entity that owns the underlying income-producing real property. The mezzanine borrower typically owns directly or indirectly all of the equity of the mortgage borrower, making the mortgage borrower, in effect, a wholly-owned subsidiary of the mezzanine borrower.

¹³ With a mortgage borrower, the principal collateral for the secured loan is the borrower's direct ownership of real property. The mortgage borrower typically owns the real property outright in fee simple absolute, although in some cases, the mortgage borrower owns only a long-term leasehold interest.

¹⁴ Joseph Forte, *Mezzanine Finance: A Legal Background*, COMMERCIAL SECURITIZATION FOR REAL ESTATE LAWYERS (Apr. 2004) at 442, available at SJ090 ALI-ABA 437 (Westlaw) [hereinafter *Forte, Mezzanine Finance*].

¹⁵ The term "Preferred Member" refers to the financing source or "lender" and the term "Preferred Equity Borrower" refers to the entity in which the Preferred Member makes its capital contribution or other investment. As discussed below, oftentimes the Preferred Equity Borrower is also the mortgage borrower.

or indirectly) owns all of the equity interests of the underlying mortgage borrower.¹⁶ Unlike other equity investors in the entity, however, the financing source has special rights: (i) the right to receive a special (or preferred) rate of return on its capital investment,¹⁷ and (ii) the right to an accelerated repayment of its initial capital contribution.¹⁸ In effect, the preferred rate of return reflects the interest component of a conventional loan, and the accelerated repayment of the investor's capital is analytically similar to the repayment of outstanding principal in a loan.

The rapid success of mezzanine loans and preferred equity investments indicates more than just market demand for new and popular financial products. These new financings are quickly (and quietly) replacing conventional junior mortgages as the principal means to provide property owners with additional financing. In so doing, these new financing techniques have not only fundamentally transformed the real estate capital markets but also marked a new chapter in the history of real estate finance. The conventional wisdom on real estate finance is no longer true: real estate finance is not limited simply to the many varieties of mortgage products in the primary and secondary mortgage market. Now, commercial property owners have a new array of new financing techniques some of which are neither directly secured by real estate nor even directly involve land.

No scholarly writing has focused on mezzanine financings and preferred equity investments. This article does so. Section I of this article describes the development of mortgage law as a new body of law separate and distinct from then existing contract law. It also highlights how courts used their equitable powers to develop an arsenal of protections such as the equity of redemption to safeguard borrowers from overreaching lenders. By applying the equity of redemption, courts focused on the underlying substance of the transaction and the lender-borrower relationship rather than the formal contracts evidencing the financing. This Section also describes the many ways in which lenders sought to undercut borrower's rights by disguising mortgage financings as other types of transactions. This historical material is particularly relevant for mezzanine loans and preferred equity investments since courts must still wrestle to find the proper balance between strict enforcement of the lenders' contractual rights and remedies with basic property law protections and equity concerns for borrowers.

¹⁶ Standard & Poor's, *Criteria on A/B Structure in CMBS Transactions* (May 15, 2000), at http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1031591714414&b=10&r=1&l=EN (last visited Dec. 1, 2005) [hereinafter *Criteria on A/B Structure*].

¹⁷ The equity investor's right to a preferred or special rate of return explains in part why many refer to the financing source as the Preferred Member. *Forte, Mezzanine Finance*, *supra* note 14, at 442.

¹⁸ *Criteria on A/B Structure*, *supra* note 16, at 19.

Section II discusses the birth of mezzanine financings and preferred equity investments. In this section, I show that traditional mortgage financings helped fuel the development of the secondary mortgage market and commercial mortgage backed securitizations. The power and significance of national rating agencies also began to grow along with CMBS transactions, and they became heavily involved with real estate finance. I argue in this Section that the national rating agencies have caused the decline of traditional junior mortgages and inadvertently created the dramatic expansion of mezzanine financings and preferred equity investments. Section III describes in greater detail mezzanine financing and preferred equity investments and the legal structure and basic underpinnings of these new financing techniques.

To date, courts have not had the opportunity to review the structure of these new financing techniques and it remains unclear whether courts will respect the crafty legal structures underlying mezzanine loans and preferred equity financings. These transaction documents raise certain fundamental issues and expose the simmering tension between contract and property law. In Section IV, I argue that junior mortgages, mezzanine loans and preferred equity financings all occupy the same intermediate position in the capital structure of a property owner (i.e., they are all subordinate to the senior mortgage, but senior in priority to the property owner's equity), mezzanine loans and preferred equity financings are in effect mortgage substitutes, and lenders are simply attempting to avoid the borrower's equity of redemption in order to minimize the hazards and delay of mortgage foreclosures. Based on the centuries-old property law adage—"once a mortgage, always a mortgage"—I conclude that the law should treat all three types of financings similarly and apply traditional property theory to these new financing techniques and treat them as mortgages.

I. Historical Development of Mortgage Financing and the Equity of Redemption

In this Section I describe the development of the world's most successful real estate financing technique: mortgage lending. By using real estate as collateral for financial transactions, property owners have been able to access financial markets and raise additional capital. At first, lenders structured these transactions to disguise the true nature of the lender-borrower relationship and to obtain extraordinary rights to real estate collateral. As a result, lenders oftentimes deprived borrowers the right to receive rents and possession from their property or to repay the loan after default. During the early common law period in England, however, courts began to disregard the formal structure of these transactions and focus instead on the true substance of the lender-borrower relationship. These equity courts soon developed

an array of rights for these borrowers, including the equity of redemption—the borrower's right to repay the debt at any time prior to mortgage foreclosure.

As discussed below in Section IV, this historical material is particularly relevant for mezzanine loans and preferred equity transactions since these new financing techniques are similar in many ways to early real estate financing techniques used in common law England. With mezzanine loans and preferred equity financings, lenders also attempt to deprive borrowers of basic property rights through enforcement of contractual rights and remedies. Since courts have not yet addressed the enforceability of many of the contract provisions found in mezzanine financings and preferred equity financings, it is only a question of time before courts will need to examine the very same issues that common law courts addressed over five hundred years ago—should the law enforce the contract documents as written or should the transactions be characterized as a mortgage substitute?

Since antiquity, property owners have used real estate as collateral for borrowing.¹⁹ Long before its first use in common law England, landowners were able to borrow money by using their property as collateral under the early laws of ancient Egypt,²⁰ Rome,²¹ Greece,²² and India,²³ the French Code of Napoleon,²⁴ and ancient

¹⁹ There are many excellent sources devoted to the historical development of the mortgage. One of the most cited and definitive treatises is GEORGE E. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES (West 2d ed. 1970) (1951) [hereinafter OSBORNE ON MORTGAGES], upon which I have relied extensively in this Section. Other major books devoted to the history of mortgage law include LEONARD JONES, A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY (1878) and RUDDEN AND MOSELEY, AN OUTLINE ON THE LAW OF MORTGAGES (1923).

Many of the classic treatises on property law also discuss the historical development of the mortgage. See generally POWELL, *supra* note 2; HERBERT THORNDIKE TIFFANY, TIFFANY ON REAL PROPERTY § 1379-1382 (1903); WILLIAM F. WALSH, A TREATISE ON MORTGAGES § 3 (1934); GEORGE W. THOMPSON, COMMENTARIES ON THE MODERN LAW OF REAL PROPERTY § 101.01 (1924).

There have also been many excellent law review articles examining the history of the mortgage. See H.W. Chaplin, *The Story of Mortgage Law*, 4 HARV. L. REV. 1 (1890); John H. Wigmore, *The Pledge Idea*, 10 HARV. L. REV. 321 (1897); Harold D. Hazeltine, *The Gage of Land in Medieval England*, 17 HARV. L. REV. 549 (1904). More recently, Ann M. Burkhart has written extensively on the development of the modern day mortgage. See, e.g., Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283 (1987) [hereinafter Burkhart, *Freeing Mortgages*]; Ann M. Burkhart, *Lenders and Land*, 64 MO. L. REV. 249 (1999) [hereinafter Burkhart, *Lenders and Land*].

²⁰ In ancient Egypt, property was used as security for marital obligations. Chaplin, *supra* note 19, at 1-2.

²¹ Roman civil law permitted the use of property as collateral for loans under the *pignus* and the *hypotheca*. Under the *pignus*, the borrower pledged its property to the lender as collateral for the loan. The lender then took possession of the property subject to the express condition that it would transfer possession back to the borrower when the borrower fully paid off the loan. Under the *hypotheca*, the borrower pledged its property to the lender as collateral but, unlike the *pignus*, the borrower retained possession of the property. The borrower also had the right to pay off the debt and redeem its collateral before the lender extinguished the borrower's rights in the hypothecated collateral. 4 JAMES KENT, COMMENTARIES ON AMERICAN LAW 136-137 & n.(a) (1884); see also JONES, *supra* note 1, at 2; 2 STORY, COMMENTARIES ON EQUITY

Israel.²⁵ Property owners in England were no exception. They too used land as collateral as early as the Anglo-Saxon period.²⁶

Although no detailed evidence is available, historians agree that the earliest instance in English law of an owner using land as collateral for a loan is the gage²⁷ of Glanville's time in the late 12th century.²⁸ Under Glanville's gage,²⁹ the gagor (the pledgor and borrower) transferred possession of its land to the gagee (the pledgee and lender) until full repayment of the debt.³⁰ The most popular gage was the "mort gage" or "mortuum vadium" (dead pledge); the creditor kept the rents and profits of the land until the debt was repaid in full.³¹ Not surprisingly, lenders overwhelmingly preferred to use the mort gage since they retained the rents, profits and possession of

JURISPRUDENCE § 1005 (1886); *Handler Constr. v. Corestates Bank*, 633 A.2d 356 (Del. 1993) (discussing the historical development of the equitable mortgage).

²² In Ancient Greece, "a pillar or tablet set up on the land, inscribed with the creditor's name and the amount of the debt" indicated that the owner had pledged the property to the creditor. Chaplin, *supra* note 19, at 5.

²³ *Id.* The entire system of the hypothecation of land as collateral was common to Indo-Europeans and was fully elaborated in the early laws of India.

²⁴ An early variation of what we now refer to as the mortgage was comparable to a similar instrument under the Code Napoleon. OSBORNE ON MORTGAGES, *supra* note 19, § 1.

²⁵ JONES, *supra* note 1, at 1 (discussing references in the Old Testament to mortgages and that ancient Jews certainly used, if not, originated, the practice of mortgaging real property); see also Wigmore, *supra* note 19, at 401-406 (discussing the historical development of pledging collateral to secure a loan under Jewish law, including the Pentateuch, the Mishna and the Ghemera); Jacob Rabinowitz, *The Story of the Mortgage Retold*, 94 U. PA. L. REV. 94 (1946) (discussing the influence of Jewish practices and legal forms on English medieval law and the development of the mortgage); Michael S. Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage*, 19-22 (June 8, 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=555972 (last visited Dec. 1, 2005) (discussing many types of loan transactions that violate the Talmud's prohibition on usury and the "equivalence between an impermissible [usurious] loan and a permissible sale followed by a redemption").

²⁶ RUDDEN & MOSELEY, *supra* note 19, at 3 (describing historical records of mortgages in early Anglo-Saxon times and in the period immediately after the Norman Conquest when the Domesday Book was being written); see also JONES, *supra* note 1, at § 1a, 3; OSBORNE ON MORTGAGES, *supra* note 19, at 4; Hazeltine, *supra* note 27, at 552.

²⁷ In Norman French, "gage" means pledge.

²⁸ OSBORNE ON MORTGAGES, *supra* note 19, at 2.

²⁹ Ranulph De Glanville, Chief Justiciar under Henry II, wrote *Tractatus de Legibus Angliæ* in about 1190. Glanville's text, in which he described the vif gage and the mort gage, is perhaps the oldest book describing the laws and customs of England. See 1 JAMES KENT, *Lecture XXII: Of the Principal Publications on the Common Law*, in COMMENTARIES ON AMERICAN LAW (Jon Roland ed., 15th ed. 1997-2002) (1826); see also POWELL, *supra* note 2, § 37.02; Burkhardt, *Freeing Mortgages*, *supra* note 19, at 305 n. 71.

³⁰ OSBORNE ON MORTGAGES, *supra* note 19, § 1 at 2-3.

³¹ *Id.*; see also SIR FREDERICK POLLOCK, *THE LAND LAWS* 132-134 (Fred B. Rothman & Co. 1979) (1883); RUDDEN AND MOSELEY, *supra* note 19, at 4;

the land while remaining entitled to repayment of principal and interest. It is that name—mort gage or mortgage—that has remained.³²

Because the gage was basically unfair to borrowers, the Bractonian mortgage soon began to replace Glanville's gage in the thirteenth century.³³ Although there were variations, the Bractonian mortgage basically required the borrower to transfer an estate for years and legal possession to the lender. Typically, the borrower had the right to recover the property upon payment of the debt, but if the borrower failed to repay the debt the lender's title automatically converted itself into a fee simple absolute.³⁴ While the Bractonian mortgage was clearly an advance over Glanville's gage for both lenders and borrowers, lenders still remained dissatisfied since the law required lenders to prove both the existence of the debt and the validity of their title.³⁵

As a result, by approximately the end of the 15th century, Littleton's gage—the direct forerunner of what we now refer to as the common law mortgage—soon began to displace the Bractonian mortgage.³⁶ Under this type of arrangement, the borrower conveyed a determinable fee to the lender retaining a reversionary interest; upon the borrower's repayment of the debt, the lender's estate automatically ended and the borrower could exercise its right of reentry and recover the land from the lender.³⁷ Furthermore, if the borrower breached the condition by failing to repay the debt on the due date (often referred to as the "law day"),

³² Morris G. Shanker, *Will Mortgage Law Survive?: A Commentary and Critique on Mortgage Law's Birth, Long Life, and Current Proposals for Its Demise*, 54 CASE W. RES. L. REV. 69, 71-72 (2003); see also Burkhart, *Lenders and Land*, *supra* note 27, at 252; Chaplin, *supra* note 27, at 8.

³³ OSBORNE ON MORTGAGES, *supra* note 19, § 4.

³⁴ Chaplin, *supra* note 19, at 8; Hazeltine, *supra* note 19, at 556.

³⁵ Chaplin, *supra* note 19, at 9; OSBORNE ON MORTGAGES, *supra* note 19, at 7-8.

³⁶ There is no clear consensus on exactly when Littleton's gage became the dominant form of mortgage, but the dates range from the thirteenth century to the early sixteenth century. OSBORNE ON MORTGAGES, *supra* note 19, § 5 at 8 (arguing that in the fourteenth century the conveyance of the fee upon condition subsequent emerged as the dominant form of mortgage); POWELL, *supra* note 19, § 37.02 (noting that in 1475, Littleton "described a mortgage as a conveyance upon condition that if the debtor paid upon the due date . . . he might re-enter"); RUDDEN & MOSELEY, *supra* note 19, at 4 ("[B]y the end of the 15th century, most lenders insist that the land be conveyed to them *in fee simple*" subject to a condition that the borrower may reenter the land upon satisfaction of the debt.); Chaplin, *supra* note 19, at 9 (finding that the outright conveyance of the fee conditioned upon the subsequent condition of borrower's repayment of the debt appears in the legal records in the thirteenth century); Cf. Hazeltine, *supra* note 19, at 557 (suggesting that the common law mortgage can be "found in the sources of the law long before the time of Littleton" in the twelfth and thirteenth centuries).

³⁷ See OSBORNE ON MORTGAGES, *supra* note 19, § 5, at 9; POWELL, *supra* note 2, at § 37.02; RUDDEN & MOSELEY, *supra* note 19, at 4; Burkhart, *Freeing Mortgages*, *supra* note 19, at 312-13; Chaplin, *supra* note 19, at 9; Hazeltine, *supra* note 19, at 556-57.

absolute title automatically vested with the lender and the borrower forever lost its land.³⁸

In some ways, Littleton's gage was a peculiar structure for securing a financing transaction since the lender obtained legal title immediately upon making the loan. "Although the essence of the relationship between the borrower and the lender was merely a debt relationship, the law closed its eyes to the true character of the transaction and accorded the lender all the rights of fee ownership."³⁹ Under Littleton's gage, the lender received the legal benefits of fee ownership of the land even though the parties intended only to secure the borrower's obligation to repay the lender.⁴⁰ Perhaps most important, the lender also had the legal right to immediate possession of the land even prior to the borrower's default.⁴¹

From the first use of Glanville's gage to Bracton's mortgage and then Littleton's gage, the lender increasingly obtained stronger rights in the mortgaged land. The culmination of this trend was Littleton's gage where the lender actually obtained fee title to the mortgaged land with almost all the rights incident to absolute ownership, including the right to possession and collection of rents and profits.⁴² Although the legal structures of Glanville's gage, Bracton's mortgage, and Littleton's gage differed, in many ways they were similar. Each intended to use the borrower's real property as collateral for a loan even though on its face each legal structure purported to do something entirely different. As with mezzanine loans and preferred equity investments—the new real estate financing techniques of the twenty-first century discussed in Section III—there was a growing chasm between the legal structures used by lenders and borrowers and the true underlying purpose of these transactions where land was basically serving as collateral security for a loan.

There was a disconnect between the legal structure and purpose of these early mortgage transactions. For example, if the borrower failed to repay the debt in the exact amount on precisely the day set, the legal structure of the common law mortgage dictated a severe result in the courts of law since the lender technically held a determinable fee. Accordingly, if the borrower failed to repay the loan on the maturity date, the borrower irrevocably forfeited its land to the lender.⁴³ This result, however, ignored the true nature of the lender-borrower relationship. By the late

³⁸ OSBORNE ON MORTGAGES, *supra* note 19, § 5, at 9; POWELL, *supra* note 2, § 37.02.

³⁹ Burkhardt, *Lenders and Land*, *supra* note 19, at 255.

⁴⁰ OSBORNE ON MORTGAGES, *supra* note 19, § 5, at 9; Burkhardt, *Lenders and Land*, *supra* note 19, at 255-56.

⁴¹ OSBORNE ON MORTGAGES, *supra* note 19, § 5, at 10-11; Burkhardt, *Lenders and Land*, *supra* note 19, at 255-56.

⁴² Burkhardt, *Lenders and Land*, *supra* note 19, at 255-56.

⁴³ OSBORNE ON MORTGAGES, *supra* note 19, § 5 at 12.

sixteenth and early seventeenth centuries, the equity courts attempted to address the harsh effects of forfeiture.⁴⁴

The equity courts allowed a borrower to avoid strict enforcement of the forfeiture provisions by developing (and the law courts later followed by enforcing) the borrower's equity of redemption.⁴⁵ By characterizing the determinable fee for what it really was—a mortgage—the equity courts permitted the borrower to recover its property upon payment of the debt within a reasonable time even after the law day.⁴⁶ At first the equity of redemption was limited to individual borrowers only where there was fraud, accident, mistake, excusable error, impossibility, "oppression, or some similar familiar ground of general equity jurisdiction."⁴⁷ But by the early part of the seventeenth century, the courts recognized the borrower's right of redemption as a general rule.⁴⁸

Faced with lenders' attempts to undercut borrowers' right to redeem, courts continued to enforce strictly the borrower's equity of redemption and refused to enforce any purported waiver or contractual limitation of the borrower's rights as an unlawful clog on the equity of redemption.⁴⁹ In an attempt to avoid the borrower's equity of redemption, lenders often structured the mortgage transaction to appear as another type of conveyance. Lenders structured these financing transactions as a

⁴⁴OSBORNE ON MORTGAGES, *supra* note 19, §6; Burkhardt, *Lenders and Land*, *supra* note 19, at 264.

⁴⁵ OSBORNE ON MORTGAGES, *supra* note 19, § 6, at 12.

Many excellent books and articles discuss the equity of redemption. *See generally* R. W. TURNER, *THE EQUITY OF REDEMPTION: ITS NATURE, HISTORY AND CONNECTION WITH EQUITABLE ESTATES GENERALLY* (1931); Jeffrey L. Licht, *The Clog on the Equity of Redemption and Its Effect on Modern Real Estate Finance*, 60 ST. JOHN'S L. REV. 452 (1985-86); Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 52 VAND. L. REV. 599 (1999); C. C. Williams, Jr., *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31 (1933-34); Bruce Wyman, *The Clog on the Equity of Redemption*, 21 HARV. L. REV. 459 (1908).

⁴⁶ OSBORNE ON MORTGAGES, *supra* note 19, § 6 at 12; Burkhardt, *Lenders and Land*, *supra* note 19, at 264.

⁴⁷OSBORNE ON MORTGAGES, *supra* note 19, § 6, at 12-13; *see also* POWELL, *supra* note 2, at § 37.02; TURNER, *supra* note 45, at 21, 25. According to Turner, the first instance of a court ordering what we now refer to as the equity of redemption dates to 1456 in a case involving highly unusual circumstances: excessive profit, imprisonment of the mortgagor in debtor's prison, and the lender's gross fraud and oppression." *Id.* at 21. There were soon other cases suggesting the court's power and jurisdiction to order equitable relief. But the equity of redemption did not develop all at once. It developed over a period of time and "only as the result of a very long succession of decisions." Chaplin, *supra* note 19, at 10.

⁴⁸ *See, e.g.*, Burkhardt, *Lenders and Land*, *supra* note 19, at 264, n.93 (citing *Hamilton v. Dirlton*, 1 Ch. Rep. 165 (1654)); OSBORNE ON MORTGAGES, *supra* note 19, §6, at 13 (citing *Emanuel College v. Evans*, 1 Ch.Rep. 18 (1625); TURNER, *supra* note 45, at 26-27 (explaining that equity of redemption was given as a matter of course and the "relief originally given in exceptional circumstances had become the rule, and the cases where no relief would be afforded had become rare exceptions"); Chaplin, *supra* note 19, at 10.

⁴⁹ OSBORNE ON MORTGAGES, *supra* note 19, §97; Licht, *supra* note 45.

conditional sale or lease with right of early termination,⁵⁰ an outright sale with another contract where the buyer-lender promises to resell the land at a higher price,⁵¹ or a conveyance to a third party to hold the land in trust for the lender's benefit if the borrower failed to repay the debt.⁵² Notwithstanding lenders' attempts to disguise what was in essence a mortgage transaction or to force the borrower to agree contractually to waive or limit its right of redemption, the law prevented lenders from circumventing or otherwise clogging the equity of redemption. In looking beyond the legal structure of the relationship to the true underlying nature of the transaction, the courts declared one of the most important and long-held doctrines in real estate law: "once a mortgage, always a mortgage." The courts amplified this doctrine with oft-repeated pronouncements such as "[t]here shall be no clog on equity of redemption" and "[t]he land shall be returned to the mortgagor exactly as he parted with it."⁵³ If the true nature of the transaction was a mortgage, the law would treat it as a mortgage.⁵⁴ As Marshall Tracht has observed, the courts regard the right of redemption as "essential, immutable, and unwaivable," and every effort by lenders to undercut the borrower's equity of redemption:

however ingenious, has been met by the unyielding resistance of the courts: one may not "clog the equity of redemption." The idea that the equity of redemption is an inherent and inseparable part of every mortgage is now so commonplace, so accepted, that it elicits relatively little comment or question.⁵⁵

Although there are many explanations for the emergence of the borrower's equity of redemption, most agree that it signaled the courts' general reluctance to

⁵⁰ This is a type of financing where the seller helps the buyer finance a portion of the purchase price for the land being sold. The device is similar to the lease for sale where the "rent" payments are really installments of the purchase price. Although tenant-buyer obtains possession, landlord-seller retains legal title until payment in full of all the installments. Typically, the contract includes a "time of the essence" provision and provides that upon default landlord-seller can recover possession and still retain all of the prior payments made by borrower-tenant. OSBORNE ON MORTGAGES, *supra* note 27, §21.

⁵¹ This is a type of financing where in the initial sale, the borrower is the "seller" and the lender is the "buyer." The stated purchase price of the initial sale is in reality the loan amount, and the borrower-seller transfers legal title to the lender-buyer as collateral security for the loan. If the borrower repays the loan in full, in the subsequent transaction, the lender is now the seller, the borrower is now the buyer, and the resale price represents the borrower-buyer's repayment of principal and all accrued interest. Upon timely payment, the lender-seller reconveys title to the borrower. As with most mortgage substitutes, there is typically a time limit on the borrower's right to repurchase so upon a default title irrevocably remains with the lender. OSBORNE ON MORTGAGES, *supra* note 19, at 31.

⁵² This type of structure is sometimes referred to as a Trust Deed Mortgage. OSBORNE ON MORTGAGES, *supra* note 19, § 21.

⁵³ TURNER, *supra* note 45, at 62; Shanker, *supra* note 32, at 77 (referring to the common statement "a mortgage by any other name is still a mortgage").

⁵⁴ JONES, *supra* note 1, § 7, at 10;; Chaplin, *supra* note 19, at 11-12.

⁵⁵ Tracht, *supra* note 45, at 600-601.

enforce forfeiture provisions. Especially where the value of the land greatly exceeded the amount owed to the lender, the forfeiture provision seemed particularly like an otherwise unenforceable penalty.⁵⁶ By refusing to enforce the harsh forfeiture provisions contained in the transaction documents, the courts simultaneously eroded the “then existing ‘freedom of contract’ rules” and began to develop mortgage law as a “unique and separate body of equity law.”⁵⁷ Prior to that time, the general principles of conveyance and contract law governed the lender-debtor relationship. Since “freedom of contract was paramount” and “[t]he parties had ‘agreed’ to their bargain,” courts generally enforced the precise terms of the documents.⁵⁸ But the equity courts looked beyond the mere words of the contract and instead developed a set of equitable principles that better served what they observed was in essence a debtor-creditor relationship.

The emergence of the borrower’s equity of redemption indicated the willingness of the courts to look at the true substance of the underlying debt transaction rather than focusing solely on the formalistic structure of the secured loan. By looking at the intent rather than the form, the court protected the parties’ reasonable expectations. If the parties truly intended to enter into a secured loan then equity would protect the parties’ expectations. The lender expected to be repaid the debt with interest in a reasonably timely manner, and the borrower expected to recover its mortgaged property upon payment of the outstanding debt.⁵⁹ The courts recognized that after the borrower paid the lender, the basic debtor-creditor relationship ended, and the lender no longer had any rights to the land or against the borrower.⁶⁰

⁵⁶ JONES, *supra* note 1, at 8-10; OSBORNE ON MORTGAGES, *supra* note 19, § 6, at 14; RUDDEN & MOSELEY, *supra* note 19, at 5-7.

⁵⁷ Shanker, *supra* note 32, at 73-74.

⁵⁸ Shanker, *supra* note 32, at 73.

⁵⁹ JONES, *supra* note 1, at 8-10; OSBORNE ON MORTGAGES, *supra* note 19, § 6, at 12; RUDDEN & MOSELEY, *supra* note 19, at 5-7.

⁶⁰ Shanker, *supra* note 32, at 74. The borrower’s right to redeem was not limitless, however. Lenders soon obtained a mechanism to end borrowers’ equitable rights in their mortgaged property. Upon application to the court, a lender could obtain a judicial decree ordering the borrower to redeem the property within a reasonable time. If the borrower failed to repay the debt prior to the end of the redemption period, he was forever barred from redeeming. OSBORNE ON MORTGAGES, *supra* note 19, § 6, at 12; POWELL *supra* note 2, § 37.02;; Shanker, *supra* note 32, at 76. The effect of this proceeding—now known as strict foreclosure—would leave the lender with good title in the mortgaged property. OSBORNE ON MORTGAGES, *supra* note 19, § 10. If the value of the land greatly exceeded the amount owed to the lender, however, the lender obtained a windfall. Realizing the basic unfairness to the borrower, equity courts soon required that the mortgaged property be sold at foreclosure; the proceeds of the foreclosure sale would be used first to pay the debtor its outstanding debt; and the balance of the sale proceeds, if any, would be distributed to the borrower. This method—foreclosure by sale or judicial foreclosure—protects both the borrower’s equity in the mortgaged property and the lender’s right to be repaid the outstanding debt, and is now the most frequent method

Notwithstanding some inherent limitations of the common law mortgage and the development of the borrower's equity of redemption in England, all of the British North American colonies that later became states adopted the wholesale use of mortgages and based their mortgage law on the common law of England.⁶¹ With the further refinement of mortgage law in the United States, it has proved adept at satisfying the financial needs of property owners, and remains the most common and successful technique to finance real estate transactions in the United States.⁶² The mortgage has proved especially durable, in part, since a property owner could easily satisfy its financing needs by simply granting a mortgage on its land. With this relatively simple transaction, the borrower received the loan proceeds and the lender typically received collateral worth much more than the loan. However, the mortgagor still retained, in law and equity, legal title to the mortgaged property for the purpose of security and general ownership. Since the law recognized the debtor's continued legal interest in its real property, the property owner was now also capable of granting additional liens in the retained legal interests to other junior lenders; and it was also legally possible for the very same parcel of real property to serve as collateral for two different mortgage loans, each held by separate lenders.⁶³ As a result, the borrower could easily raise additional capital by simply granting another lender a junior mortgage on its property.

In part, the success of mortgage financing is due to a legal system that has developed a clear set of rules governing the rights and liabilities of mortgagor and mortgagee and the relative priorities among competing mortgagees all holding mortgages on the same parcel of land.⁶⁴ Although both senior and junior lenders held mortgages on the same property, their relative rights differed significantly by virtue of the common law rule of "first in time, first in right"⁶⁵ and later because of

of foreclosure. Shanker, *supra* note 32, at 76 (noting that some jurisdictions still permit the limited use of strict foreclosure); see also OSBORNE ON MORTGAGES, *supra* note 19, § 10.

⁶¹ Robert H. Skilton, *Developments in Mortgage Law and Practice*, 17 TEMP. L. REV. 315, 316 (1943).

⁶² See *supra* notes 3, 5, 6 and accompanying text.

⁶³ Charles J. Reid, Jr., *The Seventeenth-Century Revolution in the English Land Law*, 43 CLEV. ST. L. REV. 221 (1995).

⁶⁴ Chaplin, *supra* note 19, at 12 (stating that by early colonial times, around 1600, mortgage law was already "perfectly well settled in England"); see also POWELL *supra* note 2, at 37-39 (by the middle of the eighteenth century, when Blackstone wrote, the "basic features of the modern mortgage had crystallized" and although there have since been additions and adaptations, "the basic features have remained unchanged"); George Lee Flint, Jr. & Marie Juliet Alfaro, *Secured Transactions History: The First Chattel-Mortgage Acts in the Anglo-American World*, 30 WM. MITCHELL L. REV. 1403 (2004) (discussing the development of the legal rules applicable to multiple lenders holding chattel mortgages in the same non-possessory collateral).

⁶⁵ See Richard A. Epstein, *Past and Future: The Temporal Dimension in the Law of Property*, 64 WASH. U. L.Q. 667 (1986). See also JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY*

the recording statutes.⁶⁶ In this way, the lowly mortgage proved quite flexible in providing financing, liquidity and capital for most real estate owners while at the same time protecting the collateral and security interests for mortgage lenders.

Until recently, mortgage financing proved satisfactory for most property owners to fulfill their financing needs. It was flexible, simple, cheap, and provided the borrower with strong protections against an overly aggressive or overreaching lender. Perhaps most important, however, because the financial markets so readily accepted junior mortgage financing, property owners could easily and efficiently raise capital over and beyond the amount financed solely from the senior mortgage lender.⁶⁷ Although this relatively simple model of real estate financing has served property owners well for centuries, I conclude that in the last ten years real estate finance has fundamentally changed, and property owners now increasingly avoid (or are prohibited from incurring) junior mortgage debt.⁶⁸ The following section describes the spectacular growth of mortgage-backed securitizations along with the rising power of the national rating agencies, and also helps explain why commercial property owners now increasingly rely on mezzanine loans and preferred equity investments instead of junior mortgage financings.

II. From Dirt to Securities to Equity: The Development of Non-Traditional Financing Techniques

In this Section I discuss the development of two new real estate finance techniques—mezzanine financings and preferred equity investments. In Subsection A, I discuss the development of the secondary mortgage market, and, in particular, the spectacular growth of commercial mortgage-backed securitizations (CMBS).⁶⁹ In

(5th ed. 2002) (citing maxim of Roman Law “Qui prior est tempore potior est jure” (Who is first in point of time is stronger in right)).

⁶⁶ The first (recorded) mortgage would be senior in priority to the second mortgage, and conversely, the second mortgage would be subordinated and junior to the first mortgage.

⁶⁷ Steven Horowitz & Lisa Morrow, *Mezzanine Financing*, in REAL ESTATE FINANCING DOCUMENTATION: STRATEGIES FOR CHANGING TIMES (2004), available at SJ005 ALI-ABA 541, 544 (Westlaw) (it has been “fairly common until recent years for the Mortgage Borrower to obtain higher loan proceeds by also granting a second mortgage on its property to a subordinate lender”); see also Diane Hess, *When You Borrow Against the House*, REAL ESTATE JOURNAL at <http://www.realestatejournal.com/buysell/mortgages/20050621-hess.html> (last visited Dec. 1, 2005).

⁶⁸ See *infra* notes 153-57 and accompanying text.

⁶⁹ There are many excellent sources devoted to the historical development of the secondary mortgage market and mortgage securitizations, including the following (listed in chronological order): Richard Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1 (1971) [hereinafter Bartke, FNMA]; Robin Malloy, *The Secondary Mortgage Market: A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991 (1986) [hereinafter Malloy, *Catalyst for Change*]; David Richards, *Gradable and Tradable: The Securitization of Commercial Real Estate Mortgages*, 16 REAL EST. L.J. 99 (1987) [hereinafter Richards, *Gradable and Tradable*]; BARTLETT,

Subsection B, I discuss the growth and rising power of the national rating agencies and their specialized role and increasing involvement with real estate finance. And, in subsection C, I demonstrate that the national rating agencies have caused the decline of traditional junior mortgages and inadvertently created the dramatic expansion of new non-traditional financing techniques—in particular, mezzanine financings and preferred equity investments.

A. From Dirt to Securities—The Growth of the Secondary Mortgage Market

The advent of the secondary mortgage market and the “securitization” of mortgages began in earnest with the economic depression of the 1930s when large scale defaults by consumers on their home mortgages led many banks to withdraw from lending in the residential mortgage market.⁷⁰ In response to the depressed residential mortgage market and increasing withdrawals of consumer deposits, Congress intervened in the housing finance system with a variety of legislative initiatives, including new programs and administrative agencies devoted exclusively to improving the residential mortgage loan market.⁷¹ These new programs included: (i) Federal Home Loan Bank System (FHLBS), (ii) Federal Housing Administration (FHA), (iii) Federal National Mortgage Association (affectionally known as “Fannie Mae” and more prosaically as “FNMA”), the first governmental agency to make a secondary market in residential mortgages by purchasing insured mortgage loans, and (iv) by 1944, a new insurance program at the Veterans Administration (VA) to guarantee certain mortgage loans made to veterans.⁷²

Even with these programs, however, there was little new housing construction from 1926 through 1946 due mostly to the Depression and World War II. Additionally, with the exception of Fannie Mae’s purchases of FHA-insured and VA-insured residential mortgages, the secondary mortgage market remained largely

MBS, *supra* note 9; Shenker, *Asset Securitization*, *supra* note 9; Forte, *Wall Street Key Player*, *supra* note 9.

In addition, the web sites for Ginnie Mae, Freddie Mac and Fannie Mae each provide an easy to understand overview of their respective legislative and programmatic histories. Information for Ginnie Mae, *available at* www.ginniemae.gov; Information for Freddie Mac, *available at* www.freddiemac.com; Information for Fannie Mae, *available at* www.fanniemae.com.

⁷⁰ Many mortgages loans during this period had very low “loan-to-value ratios of about 40%, were short term, [required borrowers to pay] . . . interest semi-annually, and involved a balloon payment, often as short as three or five years. In part it was the non-amortizing feature of these balloon mortgages that contributed to the high default rates of the Depression years.” BARTLETT, MBS, *supra* note 9, at 4-5.

⁷¹ Carrie Lavargna, *Government Sponsored Enterprises are “Too Big to Fail”: Balancing Public and Private Interests*, 44 HASTINGS L.J. 992, 1000-02 (1993).

⁷² See Bartke, *FNMA*, *supra* note 69, at 14-18; Malloy, *Catalyst for Change*, *supra* note 69, at 992-95.

inactive during the 1950s and most of the 1960s.⁷³ But that changed when the government once again sought to increase significantly the availability of capital to finance home ownership. In a spurt of legislative activity beginning around 1968, Congress made Fannie Mae quasi-private, expanded its permitted activities, and continued its authority to borrow directly from the Treasury at below market interest rates. It also separated Fannie Mae into two distinct entities⁷⁴ and created two other entities—the Government National Mortgage Association (“Ginnie Mae” or GNMA)⁷⁵ and the Federal Home Loan Mortgage Corporation (“Freddie Mac” or “FHLMC”).⁷⁶

During the 1970s and early 1980s, there was a slow and steady development of various residential mortgage-backed securities (RMBS). In 1970, Ginnie Mae issued pass-through certificates backed by FHA-insured and VA-insured mortgages. Freddie Mac in 1971 issued guaranteed mortgage participation certificates backed by conventional mortgages. And, in 1981, Fannie Mae introduced its guaranteed MBS program for conventional mortgages.⁷⁷ During this early period, the securitization market developed at an astounding rate—at first for GNMA, FNMA, and FHLB and later for private corporations and investment banks. The total issuance of securities by Ginnie Mae, Freddie Mac and Fannie Mae went from just \$0.5 billion in 1970, to \$8 billion in 1975, to \$23.1 billion in 1980, and to \$108.2 billion in 1985. Just two years later in 1987, their combined issuance of mortgage-backed securities more than doubled to \$225 billion.⁷⁸ By 2003, it exceeded \$432 billion.⁷⁹

⁷³ Shenker, *Asset Securitization*, *supra* note 9, at 1381-82.

⁷⁴ Section 302(c)(2) of Title II of the National Housing Act states: “On September 1, 1968, the body corporate described in the foregoing paragraph [Fannie Mae] shall cease to exist in that form and is hereby partitioned into two separate and distinct bodies corporate, each of which shall have continuity and corporate succession as a separated portion of the previously existing body corporate.” 12 U.S.C. § 1716(b) (1968).

⁷⁵ Congress created Ginnie Mae on September 1, 1968 pursuant to Section 302(c)(2)(A) of Title III of the National Housing Act, 12 USC § 1716. Section 302(c)(2)(A) states: “One of such separated portions [of the formerly existing Fannie Mae] shall be a body corporate without capital stock to be known as Government National Mortgage Association . . . which shall be in the Department of Housing and Urban Development.” 12 USC § 1716 (1968).

⁷⁶ See Federal Home Loan Mortgage Corporation Act, Title III of the Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 303(a), 84 Stat. 450, 452 (codified as amended at 12 U.S.C. § 1452(a) (1994)); see also John C. Cody, *The Dysfunctional “Family Resemblance” Test: After Reves v. Ernst & Young, When are Mortgage Notes “Securities”?*, 42 BUFF. L. REV. 761, 767 (1994); Lisa M. Fairfax, *When You Wish Upon A Star: Explaining The Cautious Growth Of Royalty-Backed Securitization*, 1999 COLUM. BUS. L. REV. 441, 447 (1999).

⁷⁷ BARTLETT, MBS, *supra* note 9, at 8-9; Shenker, *Asset Securitization*, *supra* note 9, at 1384.

⁷⁸ BARTLETT, MBS, *supra* note 9, at 19.

⁷⁹ In calendar year 2003, there were \$92.3 billion and \$303 billion of home mortgages made by government sponsored enterprises and GSE-backed mortgage pools, respectively. And, there were \$10.9 and \$26.6 billion of multifamily residential mortgages made by government sponsored enterprises and GSE-backed mortgage pools, respectively. Board of

Many factors helped the rapid growth of the residential MBS market: loan documentation for residential mortgages was relatively homogeneous and standardized; the land serving as collateral was fairly comparable; and since many residential mortgages had similar maturities and interest rates, it was often easy to assemble pools of loans with similar underlying financial attributes. In addition, as discussed above, many residential loans were insured or guaranteed either by federal instrumentalities or quasi-public entities like Fannie Mae, Ginnie Mae and Freddie Mac or by private mortgage insurance making them almost risk-free investments.⁸⁰ The tremendous acceleration of private label RMBS was also due in part to the high interest rates in the late 1970s and 1980s and the ensuing Savings and Loan (S&L) insolvency crisis.

In short, the S&L crisis, as it has since come to be known, refers to the “massive insolvencies of hundreds of savings and loan associations,” their forced liquidations, and the sell-off of their inventory of mortgage loans—the prime assets owned by the S&Ls.⁸¹ Although the factors that led up to and caused the debacle are numerous and varied (and beyond the scope of this article), it resulted in the creation of a new entity, the Resolution Trust Corporation (RTC), to dispose of the insolvent thrifts’ principal assets—billions of dollars of mortgage loans.⁸² To accelerate the sell-off of the mortgage portfolios, the RTC began to issue residential mortgage-backed securities (MBS) backed by pools of mortgage loans formerly held by the S&Ls. With the RTC’s issuance of residential MBS, investor awareness and market acceptance increased, and the market expanded even more.⁸³

At the same time, the S&L crisis particularly affected the developing CMBS market since the failed S&Ls owned not just residential mortgages but also large portfolios of commercial mortgages. As with the residential mortgages formerly held by the failed savings and loan associations, the RTC also began selling off their commercial mortgages.⁸⁴ The RTC discovered that the securitization market was an efficient and fast method to sell large inventories of commercial mortgage loans. As

Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, Tables F.218 and F.219 (Dec. 9, 2004), available at <http://www.federalreserve.gov/releases/z1/20041209> (last visited Dec. 1, 2005).

⁸⁰ Richards, *Gradable and Tradable*, *supra* note 69, at 111.

⁸¹ LAWRENCE WHITE, *THE S&L DEBACLE—PUBLIC POLICY LESSONS FOR A BANK AND THRIFT REGULATION 3* (1991) [hereinafter WHITE, *S&L DEBACLE*].

⁸² *Id.* at 176, 178.

⁸³ Joseph Forte, *Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J. 489, 495 (1996) [hereinafter Forte, *Ratable Model*] (citing statistics generated by The E&Y Leventhal Real Estate Group, 1995/1996 COMMERCIAL BACKED SECURITIZATION SURVEY, *Trends and Developments*, 1996, at 1).

⁸⁴ Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 528 (2001).

Joe Forte, a leading CMBS practitioner, has observed, the RTCs activity had profound effects on the mortgage securitization market, including increased investor awareness, an expanded base of investors, and cost efficiencies. Perhaps, most important, the RTC legitimized the CMBS market, thereby making it an attractive option to dispose of commercial mortgages in the secondary market.⁸⁵ As a result, the pace of CMBS issuances has been simply staggering: \$1.6 billion in 1990 (before the RTC issued any CMBS), to \$30 billion issued in 1996 with over \$100 billion in CMBS outstanding that year.⁸⁶ More recently, Fitch Ratings recently estimated that there was approximately \$572 billion in CMBS outstanding as of 2004.⁸⁷

B. The National Rating Agencies and CMBS

The CMBS industry has impacted the real estate capital markets from Main Street to Wall Street, affecting mortgage borrowers, major financial institutions, and other commercial lenders, both in the United States and the overseas financial markets.⁸⁸ This section describes an under-examined effect of the rise of CMBS: the concomitant involvement of national rating agencies in the CMBS market along with their increased control over the actual practice of real estate finance. In particular, the rating agencies have inadvertently stifled junior mortgage financing while at the same time contributing to the rapid rise of two new types of non-traditional financing techniques: mezzanine financings and preferred equity investments.

There are currently four rating agencies that are nationally recognized in the United States: Moody's Investors Services, Standard & Poor's, Fitch, Inc., and Dominion Bond Rating Service Limited.⁸⁹ Of the four, Moody's and Standard & Poor's by far dominate the industry with a combined market share in excess of 80%.

⁸⁵Forte, *Wall Street Key Player*, *supra* note 9, at 35.

⁸⁶*Id.* at 34-35 (citing statistics generated by The E&Y Leventhal Real Estate Group, 1995/1996 COMMERCIAL BACKED SECURITIZATION SURVEY, 1996, at 1).

⁸⁷ MBA Staff, *Positive Real Estate Lending Outlook, Experts Say*, MBA COMMERCIAL/MULTIFAMILY NEWSLINK, May 5, 2005, available at www.mortgagebankers.org/cmnewslink/issues/2005/05/05.asp (last visited Dec. 1, 2005).

⁸⁸ See, e.g., Michael Schill, *The Impact of Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269 (1999) [hereinafter Schill, *Impact of Capital Markets*]; Kingsly Greenland, *Why Liquidity Should Help You Sleep Better*, NAT'L REAL EST. INV., June 1, 2005, available at 2005 WLNR 9459228 (Westlaw).

⁸⁹ The Securities and Exchange Commission recognizes only these four credit rating agencies as Nationally Recognized Statistical Rating Organizations (NRSRO). See *infra* note 205 and accompanying text. It was only recently, on February 24, 2003, that the SEC approved Dominion Bond Rating Service Limited as the fourth NRSRO. Dominion Bond Rating Service Ltd., SEC No-Action Letter, Feb. 24, 2003, available at <http://www.sec.gov/divisions/marketreg/mr-noaction/dominionbond022403-out.pdf> (last visited Nov. 7, 2005); Credit Rating Agencies-NRSROs, at <http://www.sec.gov/answers/nrsro.htm> (last visited Nov. 7, 2005).

Fitch's market share constitutes approximately another 15%.⁹⁰ As a result, these three rating agencies effectively control over 95% of the market.⁹¹ Since the formation of these rating agencies, the financial markets have relied upon their opinions regarding the creditworthiness of publicly traded companies and the issuance of debt and securities obligations.⁹²

Although there is a long history of rating agencies reviewing public companies and various debt and securities offerings, until the mid 1980s rating agencies were seldom involved with the commercial real estate market, let alone with CMBS. Due to the absence of national credit ratings and the resulting lack of a standard means to evaluate real estate investments, major investors like pension funds, other financial institutions, and foreign investors avoided CMBS.⁹³ In order to gain market acceptance and to make it easier for potential investors to evaluate new CMBS products, the issuers of these CMBS products sought rating agency review. Accordingly, in the mid-1980s, the major rating agencies began to rank various debt

⁹⁰ Claire Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 59 (2004).

⁹¹ Richard Shelby, Senator, U.S. Senate Committee on Banking, Housing, and Urban Affairs, Statement: "Examining the Role of Credit Rating Agencies in the Capital Markets," (Feb. 8, 2005) at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Testimony&TestimonyID=743&HearingID=136> (last visited Dec. 1, 2005) ("Moody's, S&P and Fitch represent 95% of the market share").

⁹² In addition, since 1975, the SEC and Congress have used credit ratings issued by certain approved rating agencies (defined as Nationally Recognized Statistical Rating Organizations (NRSROs)) under various federal securities laws to augment and sometimes even substitute for its own review of complex financial matters. The term NRSRO was first adopted in 1975 with Rule 15c3-1 (the so-called "Net Capital Rule") for use in conjunction with determining the net capital requirements of broker-dealers who held certain types of proprietary securities. Since then, however, the SEC has incorporated the definition of NRSROs in many different regulations issued under the Securities Act of 1933, the Exchange Act of 1934, and the Investment Company Act of 1940. For example, under the Securities Act of 1933, certain asset-backed and other securities may be registered with Form S-3—the short-form registration statement—if at least one NRSRO rates the securities being offered as investment grade. SEC. AND EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 5-6 (Jan. 2003), available at <http://www.sec.gov/news/studies/credratingreport0103.pdf> (last visited Dec. 1, 2005).

According to the SEC, since 1975 four additional rating agencies have been recognized as NRSROs. However, each of these firms has since merged with or been acquired by other NRSROs. These four additional rating agencies were Duff and Phelps, Inc., McCarthy, Crisanti & Maffei, Inc., IBCA Limited and its subsidiary, IBCA, Inc., and Thomson BankWatch, Inc. Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Securities Act Release No. 8236, Exchange Act Release No. 47972, Investment Company Act Release No. 26066, 80 SEC Docket 1003 (June 12, 2003), available at http://www.sec.gov/rules/concept/33-8236.htm#P25_3179; see also Richard Sylla, *A Historical Primer on the Business of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 23 (Richard M. Levich et al. eds., 2001).

⁹³ Andrea R. Priest, *New Rating System at S&P Seen Aiding: Commercial Mortgage Secondary Market, BOND BUYER*, Nov. 27, 1984, at 4.

and securities offerings secured by commercial real estate.⁹⁴ At first, the rating agencies only evaluated debt secured by single commercial office buildings and multi-family properties,⁹⁵ but soon the agencies also rated securities and debt secured by other types of commercial, industrial, and retail properties.⁹⁶

From those early beginnings, the agencies now rate offerings of debt and securities that are secured by a vast array of commercial real estate and mortgage loans with exceedingly complex and individualized loan provisions, including both fixed-rate and floating-rate interest loans.⁹⁷ For example, Fitch now has underwriting criteria and published reports and studies on diverse transactions such as single-borrower loans, distressed real estate loans, loans secured by leases with AAA-credit tenants, and floating-rate commercial mortgages.⁹⁸ Similarly, S&P has published underwriting guidelines for an increasingly vast array of mortgage loans including single-property, multiple property, and large loan transactions; one S&P publication alone contains almost 250 pages of detailed analysis and legal criteria for various

⁹⁴ In 1984, Standard & Poor's first began rating CMBS. See *id.* Duff & Phelps (now known as Fitch) and Moody's followed shortly thereafter with ratings of commercial properties in October 1986 and December 1986, respectively. See Richard Ringer, *Duff & Phelps Expands Ratings List By Evaluating Mortgage Securities*, AM. BANKER, Oct. 23, 1986, at 8; Evelyn Wallace, *Moody's to Begin Rating Securities Backed by Commercial-Property Loans*, BOND BUYER, Dec. 29, 1986, at 3.

⁹⁵ Richards, *Gradable and Tradable*, *supra* note 69, at 114.

⁹⁶ Carl Kane & Stan Ross, *Revisions in Bond Rating System to Allow Cash Flow Use from Real Estate Loans*, AM. BANKER, Jan. 25, 1985 at 20; Richards, *Gradable and Tradable*, *supra* note 69, at 114 (although the agencies all initially refrained from rating debt secured by hotels, gas stations, movie theaters and other service-oriented properties).

⁹⁷ Fitch rates all types of mortgage-backed fixed income securities in the U.S., including multiple-borrower multiple asset, single-borrower multiple asset, nonperforming assets, single borrower single asset, credit tenant lease-backed, and real estate related CDO's. Fitch Ratings, Coverage, at http://www.fitchratings.com/corporate/sectors/sector.cfm?sector_flag=2&marketsector=2&body_content=about (last visited Dec. 1, 2005).

⁹⁸ Fitch Ratings, RATING SINGLE-BORROWER COMMERCIAL MORTGAGE TRANSACTIONS, available at http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=225816§or_flag=2&marketsector=2&detail= (Nov. 11, 2004) (last visited Nov. 7, 2005); Fitch Ratings, CREDIT TENANT LEASE LOANS, available at http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=48513§or_flag=2&marketsector=2&detail= (Apr. 22, 1999) (last visited Nov. 7, 2005); Fitch Ratings, SECURITIZING DISTRESSED REAL ESTATE (Apr. 9, 1999) (on file with author); Fitch Ratings, RATING FLOATING-RATE COMMERCIAL MORTGAGE TRANSACTIONS (Dec. 1, 1999) (on file with author).

types of CMBS transactions.⁹⁹ And, of course, Moody's also has its own guidelines that are just as extensive and demanding as those of its peers.¹⁰⁰

In evaluating CMBS transactions, the rating agencies assess a multitude of factors in an attempt to evaluate the overall credit worthiness of debt obligations or securities.¹⁰¹ Based on their respective underwriting criteria and individualized rating systems, each rating agency, after an exhaustive analysis of the various factors, assigns a rating or grade to the various "tranches" ¹⁰² of the CMBS transaction.¹⁰³ Standard & Poor's, for example, might rate the first and safest tranche of a CMBS, "AAA", the second tranche, "AA", the third tranche, "BBB", and the riskiest tranche, "B."¹⁰⁴ The assigned credit rating is the underpinning of the entire CMBS transaction since it directly affects pricing and therefore also the investment

⁹⁹ Standard and Poor's, U.S. CMBS LEGAL AND STRUCTURED FINANCE CRITERIA (May 1, 2003), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/040103_cmbslegalcriteria14.pdf (last visited Dec. 1, 2005) [hereinafter *S&P Criteria*].

¹⁰⁰ Moody's Investor Services, STRENGTH IN STRUCTURE: MOODY'S APPROACH TO RATING SINGLE-FAMILY HOUSING BONDS SECURED BY MORTGAGE-BACKED SECURITIES (Oct. 23, 1998), *available at* <http://www.moody.com/moodys/cust/research/MDCdocs/18/10146.pdf> (last visited July 12, 2005); Moody's Investor Services, US CMBS: MOODY'S APPROACH TO RATING FUSION TRANSACTIONS (Apr. 19, 2005), *available at* <http://www.moody.com/moodys/cust/research/MDCdocs/19/2003300000429425.pdf> (last visited July 12, 2005).

¹⁰¹ The rating agencies examine (i) the reliability and amount of the cash flow generated by the pool of underlying mortgages; (ii) the liquidation value of the underlying real estate upon foreclosure of the underlying collateral; (iii) the credit support or other third-party guarantees of the obligations; (iv) the likelihood that any other creditor will have claims to the underlying collateral or to other assets of the issuer; (v) certain bankruptcy related risks such as the possibility of substantive consolidation, insolvency, and bankruptcy; (vi) stress tests which analyze the economic effects, if any, if the underlying mortgages are prepaid; (vii) the diversity of the underlying pool of mortgages with respect to location, type of collateral, and interest rate; (viii) the amount of over-collateralization; (ix) the structure of the entity holding the underlying collateral (which is typically structured as a single-purpose bankruptcy remote entity); (x) loan-to-value and debt-service-coverage ratios; (xi) interviews with issuers; and (xii) whether the mortgages in the collateral package permit additional secured or unsecured indebtedness. Jennifer Goldblatt, *Loans Behind Mortgage-Backeds Due for Test*, AM. BANKER, Feb. 19, 1998, at 16.; *Fitch Alters CMBS Rating Model*, COM. MORTGAGE ALERT, Oct. 9, 2000, at 3; *Ratings Boost MBS Market*, NAT'L MORTGAGE NEWS, Nov. 7, 1988, at 5.

¹⁰² The term "tranche" refers to one or more related securities offered at the same time and secured by the same pool of underlying securities. Typically, each tranche has different characteristics regarding risks and benefits.

¹⁰³ See Poindexter, *supra* note 84, at 537 (underwriter and seller design securities in response to the assigned ratings by varying for each tranche factor, including interest rate, expected maturity, yield, and cash flow).

¹⁰⁴ The tranche rated B is referred to as the "B" piece. At S&P, a "B" rating means that there is a greater vulnerability to default but that there is current capacity to meet its loan obligations, although adverse economic and financial conditions will likely impair the ability to repay interest and principal. Steve Bergsman, *Examining the Rating Agencies: How Well Do They Fare Under Glass?*, NAT'L REAL EST. INV., Aug. 1, 1996, at 8, *available at* 8/1/96 NAT'L REAL EST. INV. 48(Westlaw).

decisions of purchasers.¹⁰⁵ Although each potential purchaser might assess its risk tolerance differently when making personal investment decisions, there are still fairly uniform economic effects on securitization transactions. As described above, lower ratings signify higher risk; the market demands higher interest yields to compensate for the higher risk; and higher interest yields cost the issuer money as a result of higher interest costs and/or lower cash proceeds realized upon the issuance of the CMBS.¹⁰⁶

The rating agencies have also developed underwriting guidelines to help market participants understand the ratings process. As discussed below, the guidelines cover almost every aspect of the CMBS transaction and even include detailed criteria for each of the underlying mortgage loans comprising the pooled collateral.¹⁰⁷ By seeking the highest possible rating for each tranche of the CMBS transaction, market participants become acutely sensitive and responsive to the underwriting criteria of the rating agencies. It is not difficult to ascertain the rating agencies' criteria and their particular likes and dislikes since each disseminates its guidelines broadly on their websites, in published articles, and in public speeches of its staff.¹⁰⁸

The ratings process is an integral component of the success and continued growth of CMBS. Initially, national credit ratings helped make commercial mortgage-backed securities attractive for many new types of commercial investors. Some regulated industries such as pension funds and life insurance companies, for example, can only buy investments that are rated investment grade or higher.¹⁰⁹ Furthermore, since the ratings are consistently applied and are national in scope, investment managers are better able to compare CMBS to other possible investments such as corporate and municipal bonds.¹¹⁰ An investor could therefore compare a

¹⁰⁵ Bergsman, *supra* note 104 (rating agencies are "critical" to the CMBS process since the ratings effectively determine price).

¹⁰⁶ Schwarcz, *Alchemy*, *supra* note 3, at 136-137.

¹⁰⁷ See *infra* notes 108 and 113.

¹⁰⁸ See, e.g., Charles Citro, *CMBS: Moody's Approach To Rating Loans Secured By Ground Leasehold Interests*, COMMERCIAL REAL EST. FIN. 2003: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW (2003), available at 489 PLI/REAL 413 (Westlaw); Daniel B. Rubock, *CMBS: Moody's Approach To Terrorism Insurance After the Federal Backstop*, COMMERCIAL REAL EST. FIN. 2003: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW (2003), available at 500 PLI/REAL 335 (Westlaw); Claire Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1071 (1996) (rating agencies "dictate a significant amount of the structure of securitization transactions"); see also *supra* notes 98-100, *infra* note 113. But see Frank Partnoy, *The Siskel and Ebert of the Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 651 (1999) (describing how the internal process by which agencies actually determine a particular rating is secret and proprietary).

¹⁰⁹ Shenker, *Asset Securitization*, *supra* note 9, at 1398 n.137.

¹¹⁰ Kane & Ross, *supra* note 96, at 20; see also Priest, *supra* note 93, at 4.

“AAA” CMBS investment to a “AAA” corporate bond.¹¹¹ According to many market participants, the rating agencies’ detailed analysis also has increased the availability of public information concerning real estate.¹¹² As more commercial investors enter into the CMBS market, it becomes safer, more liquid, and more like other capital market investments, all of which further fuels the growth of CMBS.

C. National Rating Agencies’ Impact on Commercial Real Estate Finance

The ratings process has drastically influenced the origination of commercial mortgage loans and the growth of the CMBS market. The rating agencies have changed some of the basic fundamentals of real estate finance, affecting the relationships among market participants, the basic legal structure of the underlying mortgage loans included in CMBS transactions, and the contractual arrangements of other lenders providing funds directly or indirectly to the mortgage borrower.

The rating agencies achieved these dramatic results through the use of underwriting guidelines; these guidelines are extensive, demanding, and surprisingly uniform in scope and coverage.¹¹³ For example, in just one document alone, Standard & Poor’s has assembled almost 250 pages of extensive legal criteria for commercial mortgage-backed securitizations. The published criteria cover almost every conceivable topic affecting not just the legal structure of the CMBS transaction but also the underlying mortgage loans in the pool of loans serving as collateral for the CMBS transaction, including the acceptability of certain types of collateral (single property, multiple property, and large loan transactions), transfer of mortgage loans, environmental criteria, due diligence, servicing issues, substitution of property, appraisal methods, title insurance, and mortgage recording taxes.

The criteria are so extensive that they even address the actual legal terms, provisions and structure of the underlying mortgage loans contained in the pool of

¹¹¹ See Alan Kronovet, *An Overview of Commercial Mortgage Backed Securitization: The Devil is in the Details*, 1 N.C. BANKING INST. 288, 308 (1997).

¹¹² Goldblatt, *supra* note 101, at 16; see also White, *S&L Debacle*, *supra* note 81 (discussing how the growth of public capital markets in real estate has caused an explosion of information about real estate.).

¹¹³ *S&P Criteria*, *supra* note 106; Fitch Ratings, EVALUATING ADDITIONAL DEBT IN COMMERCIAL MORTGAGE TRANSACTIONS (Dec. 19, 2001), available at http://www.fitchratings.com/corporate/sectors/criteria_rpt.cfm?sector_flag=2&marketsector=2&detail=&body_content=crit_rpt (last visited Dec. 1, 2005) [hereinafter *Fitch, Evaluating Additional Debt*]; Moody’s, CMBS: MOODY’S APPROACH TO A-B NOTES AND OTHER FORMS OF SUBORDINATE DEBT (February 4, 2000), available at www.moody.com/moodys/cust/content/loadcontent.asp?c=sri_s (last visited November 30, 2004) [hereinafter *Moody’s, A-B Notes*]; see also Hill, *supra* note 108, at 1071; Cf. Bergsman, *supra* note 104, at 48.

collateral for CMBS transactions.¹¹⁴ In its published guidelines, for example, S&P opines on most every aspect of these underlying mortgage loans, including representations and warranties, the formation of special purpose bankruptcy-remote entities, acceptable intercreditor agreements, guarantees, legal opinions, cash collateral and lock-boxes, and permissible alterations to the mortgaged property. Moreover, as discussed below, there are also extensive criteria governing the type and amount of additional indebtedness that an underlying mortgage borrower may incur.¹¹⁵

Because of the uniformity and strictness of rating agency guidelines, and since a lender cannot typically change the provisions of a loan once it is made, many mortgage lenders now frequently require that all new mortgages comply with most of the guidelines. Such requirements represent attempts to ensure that new mortgage loans are acceptable to the rating agencies for inclusion in an investment grade securitization and the secondary mortgage market. Thus, even if a lender has no present intention of transferring a particular mortgage into a securitization or later selling in the secondary market, in order to maintain its liquidity and preserve the value of the mortgage loan asset, a prudent lender still ensures that all new mortgage loans satisfy most of the rating agencies' requirements. Since all lenders are trying to comply with the same guidelines, there has been uniformity in many aspects of commercial mortgage loans.¹¹⁶

The rating agencies have significantly altered the landscape for subordinated debt because their underwriting criteria all require strict prohibitions on such subordinate financings. At their most basic, the rating agencies seek to ensure that the mortgages contained in the CMBS pool of collateral remain senior liens and that they will have first priority to the underlying collateral—the land and the flow of rental income—in case of default.¹¹⁷ From Fitch's viewpoint, additional debt in any form “puts greater stress on the cash flow of a property and increased losses in the event of default.”¹¹⁸ Similarly, Moody's takes the position that “[a]s a general rule, all subordinate debt has some adverse effect on the credit of the senior debt” since “junior debt increases the likelihood of default on the senior debt and, in some cases, increases the severity of loss on the senior piece when a default does occur.”¹¹⁹

¹¹⁴ Horowitz & Morrow, *supra* note 67, at 546 (“rating agencies have played a greater role in determining the structure of the subordinate financing and in encouraging the use of mezzanine financing as opposed to subordinate mortgage financing”).

¹¹⁵ S&P Criteria, *supra* note 99.

¹¹⁶ Schill, *Impact of the Capital Markets*, *supra* note 88, at 284 (“the requirements of the rating agencies are dictating the form and content of commercial mortgages”).

¹¹⁷ S&P Criteria, *supra* note 99, at 18.

¹¹⁸ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 1.

¹¹⁹ Moody's, *A-B Notes*, *supra* note 113, at 1.

Rating agencies particularly abhor junior mortgage debt because of the unique risks it imposes.¹²⁰ Since the junior mortgage is a direct obligation of the underlying mortgage borrower, the rating agencies believe that it adversely affects the senior mortgagee's rights and the likelihood of recovery.¹²¹ For the senior lender, the mere existence of a junior mortgage might delay and complicate its mortgage foreclosure proceedings, necessitate obtaining the junior lender's consent to a workout or other consensual modification, affect the senior lien priority of the senior mortgage or any future advances, and give the junior lender subrogation rights if the junior lender makes payments to a third party or claims the senior lender acted improperly.¹²² These risks are particularly likely since junior mortgagees frequently have the financial resources and incentive to interfere with the senior lender's exercise of its rights and remedies.¹²³

The senior mortgagee also has significant risk since most junior mortgage debt is recourse to the borrower. As a result, a borrower will have strong financial incentives to divert the reduced cash flow to the second mortgage, instead of the senior mortgage, to avoid personal liability under the recourse junior mortgage.¹²⁴ The junior mortgage debt adds increased risk especially in the event of an economic downturn since the reduced cash flows might just be insufficient to pay both the senior and junior mortgages.¹²⁵ In such a case, the mortgage borrower might default on the junior mortgage and seek bankruptcy protection, thereby hurting the senior lender.¹²⁶ In case of a default under the junior mortgage, a junior mortgagee may seek to exercise its rights and remedies and foreclose its mortgage, appoint a receiver for the rents from the tenants, and terminate leases.¹²⁷ The junior mortgagee's exercise of any of these remedies necessarily increases the likelihood of default under the senior mortgage and increases risk to the senior lender.¹²⁸

In addition, because of the increased risk of default, any type of subordinate financing also necessarily increases certain bankruptcy risks. For example, in any bankruptcy with both senior and junior mortgage lenders, there is a risk of a "cram-

¹²⁰ Jones & Simcox, *supra* note 10 at 328 ("least favorite model for all of the Rating Agencies is the second mortgage"); Horowitz & Morrow, *supra* note 67, at 545; Forte, *Mezzanine Finance*, *supra* note 14, at 440 (since the mid-1990s, the national rating agencies have been less amenable to junior mortgage financing and there has been a "growing prejudice against second mortgages").

¹²¹ Moody's, *A-B Notes*, *supra* note 113, at 7.

¹²² Forte, *Mezzanine Finance*, *supra* note 14, at 441.

¹²³ Horowitz & Morrow, *supra* note 67, at 545.

¹²⁴ Forte, *Mezzanine Finance*, *supra* note 14, at 441.

¹²⁵ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 6.

¹²⁶ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 6.

¹²⁷ Forte, *Mezzanine Finance*, *supra* note 14, at 441.

¹²⁸ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 6.

down"¹²⁹—a junior creditor forcing a bankruptcy reorganization plan on the senior mortgage lender.¹³⁰ The senior lender would also be subject to the automatic stay of the Bankruptcy Code,¹³¹ possible claims by the junior lender of equitable subordination,¹³² or claims by other creditors of substantive consolidation.¹³³

The restrictions imposed by the rating agencies, therefore, attempt to reduce the likelihood and ability of another creditor filing an involuntary bankruptcy petition against the underlying mortgage debtor or the mortgage borrower itself initiating a voluntary bankruptcy petition. As a result, it is now increasingly likely that any commercial mortgage included in a securitization prohibits the borrower from incurring any additional junior mortgage financing as well as any other significant debt even if the junior mortgage is a "soft second"¹³⁴ or otherwise "deeply subordinated" to the senior mortgage.¹³⁵ The rating agencies typically only permit the senior mortgage debt itself, contractual obligations of the mortgage borrower to tenants under leases, and certain limited types of trade debt and equipment

¹²⁹ A "cram down" is "the common parlance used by judges and practitioners when referring to the forcing of modifications down the throat of an unwilling party." Jack Friedman, *What Courts Do To Secured Creditors In Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495, 1496 (1993).

¹³⁰ *S&P Criteria*, *supra* note 99, at 18.

¹³¹ 11 U.S.C. § 362 (2005).

¹³² Forte, *Mezzanine Finance*, *supra* note 14, at 441. Under the equitable subordination doctrine, a bankruptcy court has the power to equitably subordinate a claim or interest of a lender or to avoid the lender's lien. While a claim may normally be subordinated only if the lender is guilty of misconduct to the detriment of another creditor, there are a wide variety of types of misconduct by the lender that will permit equitable subordination. See *In re Am. Lumber v. First Nat'l Bank of St. Paul*, 7 B.R. 519, 31-32 (Bankr. D. Minn. 1979).

¹³³ Under the doctrine of substantive consolidation, a single estate is created for the benefit of all creditors of all of the consolidated corporations, and combines such creditors into one creditor body. *Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966).

¹³⁴ A "soft second" is a "second mortgage that contains a subordination and intercreditor agreement between the first mortgagee and second mortgagee and restricts the actions the second mortgagee can take in the event of default . . . [and it typically contains] a standstill clause that prohibits the subordinate lender from exercising any remedies, including the commencement of foreclosure proceedings while the first mortgage is outstanding." *Fitch, Evaluating Additional Debt*, *supra* note 113, at 6. Often, a "soft second" permits the junior mortgagee to receive loan payments derived only from excess cash flow and restricts the ability to accelerate the loan while the senior mortgage loan is outstanding. Forte, *Mezzanine Finance*, *supra* note 14, at 440.

¹³⁵ Forte, *Mezzanine Finance*, *supra* note 14, at 440 (although senior mortgages do not always prohibit outright junior mortgages, most mortgage documents now customarily permit junior mortgage financing only with the consent of the senior mortgagee and review and confirmation by the relevant rating agencies).

financing.¹³⁶ These broad limitations on additional debt significantly limit the ability of the underlying mortgage borrower to incur additional debt.

But the rating agency guidelines go even further by also significantly restricting a mortgage borrower's ability to incur almost any other type of additional debt.¹³⁷ S&P's guidelines state explicitly "the borrower's right to incur additional debt, whether secured or unsecured, should generally be severely limited."¹³⁸ Similarly, Moody's demands strict limits on all forms of additional debt,¹³⁹ and Fitch typically requires increased credit enhancement or other types of additional security to compensate for the increased risk associated with additional subordinated debt.¹⁴⁰ The rating agencies' dislike of additional debt even extends to affiliated entities of the underlying mortgage borrower; consequently, the underwriting guidelines of the rating agencies typically also severely restrict loans to the separate legal entities that own indirect economic interests in the underlying mortgage borrower.¹⁴¹

All of these strict limitations are, in part, the rating agencies' attempts to protect the integrity, stability and value of the issued securities and the underlying assets of the CMBS transaction—the pool of first mortgage loans held by the securitization trust entity. By limiting junior mortgage debt, the rating agencies are also seeking to avoid "creating a significant class of junior or unsecured creditors with interests that are not necessarily the same as the interests of the holders of the rated securities."¹⁴² And, by limiting the absolute number and rights of other creditors, the rating agencies are also strategically structuring the CMBS transaction to limit the risks inherent with subordinate financings.¹⁴³

The market reality, however, is that property owners typically want to raise more funds than the first mortgage otherwise permits.¹⁴⁴ Most mortgages included in

¹³⁶ According to S&P's underwriting guidelines, "trade debt should be unsecured, not evidenced by a note, and incurred in the ordinary course of business." In addition, trade debt should be short-term obligations payable within 90 days from the date incurred. Similarly, S&P ordinarily limits equipment financing to "equipment related to the ownership and operation of the property ... [and it] should not be evidenced by a note, ... secured only by the financed equipment, ... and incurred in the ordinary course of business." See *S&P Criteria*, *supra* note 99, at 19.

¹³⁷ Forte, *Mezzanine Finance*, *supra* note 14, at 440.

¹³⁸ *S&P Criteria*, *supra* note 99, at 18.

¹³⁹ Moody's, *A-B Notes*, *supra* note 113, at 1.

¹⁴⁰ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 6.

¹⁴¹ Fitch, *Evaluating Additional Debt*, *supra* note 120 (discussing Fitch's rating process for CMBS transactions that include various forms of additional debt as collateral).

¹⁴² *S&P Criteria*, *supra* note 99, at 18.

¹⁴³ *Id.*

¹⁴⁴ Horowitz & Morrow, *supra* note 67, at 545 ("property owners may often want to borrow funds in excess of that available through first mortgage loans"); Forte, *Mezzanine Finance*, *supra* note 14, at 441 ("[b]orrowers have always tried to borrow more than lenders are willing to lend them").

securitizations typically cap the mortgage loan at a loan-to-value ratio of approximately 65% - 75%.¹⁴⁵ So, for instance, if a property is worth \$100 million, the first mortgage lender will lend \$65 - \$75 million against the value of the collateral. Whereas in the past, property owners would have simply borrowed additional funds with junior mortgage financing, that option is no longer available without violating the prohibitions of the first mortgage or jeopardizing the rating of the CMBS securities. In addition, these property owners are also unable to access the traditional capital markets with public stock offerings and issuances of long-term debentures and short-term commercial paper.¹⁴⁶

Without the ability to incur junior mortgages, property owners have sought out other sources of capital to finance amounts in excess of the senior mortgage loan and to reduce the amount of the owner's equity in the property.¹⁴⁷ The Wall Street financial community quickly responded to this new market by developing and marketing a vast array of new real estate financing techniques—in particular, mezzanine loans and preferred equity—that were acceptable to the rating agencies.¹⁴⁸ Borrowers meticulously structure each of these new financing techniques to conform to the rating agencies' guidelines and to ensure that the underlying real property is not direct collateral, and therefore does not violate any of the prohibitions or other restrictive covenants in the senior mortgage loan.¹⁴⁹

Property owners have increasingly favored combining mortgage financing along with either mezzanine loans or preferred equity as a method to obtain higher loan-to-value ratios and therefore higher proceeds.¹⁵⁰ As a result, mezzanine loans and preferred equity financings have been quickly replacing the junior mortgage as the principal means to provide owners with additional financing. Now, owners have a vast array of new financing techniques, some of which are not directly secured by real estate and do not even directly involve land. In the following Section I discuss in greater detail these new financing techniques: mezzanine loans and preferred equity investments.

¹⁴⁵ Poindexter, *supra* note 84, at 541; Horowitz & Morrow, *supra* note 67, at 544. *But see* Forte, *Mezzanine Finance*, *supra* note 14, at 442 (portfolio lenders continue to make 75% LTV mortgage loans).

¹⁴⁶ Horowitz & Morrow, *supra* note 67, at 544.

¹⁴⁷ Forte, *Mezzanine Finance*, *supra* note 14, at 440-441.

¹⁴⁸ *Id.* at 441-442.

¹⁴⁹ *Id.* at 442 ("the structure of mezzanine financing has clearly been dictated by rating agency requirements"); Horowitz & Morrow, *supra* note 67, at 546.

¹⁵⁰ *See supra* note 9 and accompanying text; Horowitz & Morrow, *supra* note 67, at 546 (if underlying mortgage is going into a securitization, it is increasingly common to combine traditional mortgage debt with mezzanine financing as a method to increase the borrower's loan-to-value ratio and obtain more loan proceeds).

III. The Emergence of Non-Traditional Financing Techniques: Mezzanine Loans and Preferred Equity Investments

A major NYC real estate developer recently completed a real estate refinancing of The Daily News Building—one of the many properties held in his vast real estate portfolio. The Daily News Building, located on East 42nd Street in midtown Manhattan, is what real estate brokers like to refer to as a “trophy” office building. It contains over one million square feet of office space, and was recently estimated to be worth approximately \$250 million dollars. Unable to sell The Daily News Building at the price he desired, the owner instead chose to refinance the property for about \$240 million dollars. After paying off the existing first mortgage from the loan proceeds of this refinancing, the owner was able to pocket almost \$80 million dollars.

How did the owner of The Daily News Building achieve this alchemy? He was able to structure a transaction that actually consisted of several separate real estate financings: (i) a first mortgage loan for \$155 million made by Deutsche Bank, (ii) a mezzanine loan for \$83 million made by Capital Trust, a New York investment fund; and (iii) a preferred equity investment in the amount of \$53 million made by SL Green, a New York real estate investment trust. While no longer unusual, this real estate owner combined conventional mortgage debt with two new non-traditional financing techniques: mezzanine financing and preferred equity investments.

A. Mezzanine Loans.¹⁵¹

The term “mezzanine financing” in the financial markets describes an array of financings such as junk bonds, unrated debt, unsecured notes, zero-coupon bonds, deferred interest debentures, and convertible loans.¹⁵² The legal structure of these financing methods varies not just by industry, but also reflects responses to unique regulatory and market concerns.¹⁵³ Typically, however, all mezzanine financing

¹⁵¹ There are many articles geared primarily for real estate practitioners that discuss the structure and legal issues of mezzanine financing, including the following: Jeanne A. Calderon, *Mezzanine Financing and Land Banks: Two Unconventional Methods of Financing Residential Real Estate Projects in the 21st Century*, 29 REAL EST. L.J. 283 (2001); Forte, *Mezzanine Finance*, *supra* note 14; Horowitz & Morrow, *supra* note 67; *see also infra* notes 167, 188.

¹⁵² Christian C. Day, Michael P. Walls & Lisa A. Dolak, *Riding the Rapids: Financing the Leveraged Transaction Without Getting Wet* 41 SYRACUSE L. REV. 661 (1990); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Finance Topics, American College of Real Estate Lawyers, Midyear Meeting, Scottsdale, Arizona (Apr. 4-5, 1997), abstract at: <http://www.acrel.org/Public/Publications/default.asp?Action=DrawOneArticle&ArticleID=2319&ArticleType=Seminar> (last visited Oct. 30, 2005).

¹⁵³ Mario L. Baeza, *Recent Developments in Leveraged Buyouts*, ACQUISITIONS AND MERGERS IN A CHANGING ENV'T, July-August, 1990, available at 700 PRAC. L. INST. 9, 47-50 (Westlaw).

refers to debt that is subordinate to another type or class of debt but senior to equity. Many have analogized it to a theater where mezzanine debt is the mezzanine section sitting between the orchestra (senior debt) and the balcony (equity).

In the real estate capital markets, the term “mezzanine financing” also refers to debt that sits between senior debt and the borrower’s equity. In this case, mezzanine debt is junior to the mortgage loan but senior to the borrower’s equity.¹⁵⁴ A mezzanine loan in the real estate industry typically refers to debt that is secured solely by the mezzanine borrower’s indirect ownership of the mortgage borrower—the entity that actually owns the income producing real property. This same underlying real property also serves as collateral for the senior mortgage lender.

In a mezzanine loan, neither the mezzanine borrower nor lender actually holds any direct real property interest in the underlying land serving as collateral. Rather, their respective interests are derived solely from the mezzanine borrower’s (direct or indirect) ownership of the equity in the underlying mortgage borrower. The mezzanine borrower grants to the mezzanine lender a lien on its equity in the mortgage borrower pursuant to a written instrument (typically a security agreement), and thereafter the mezzanine lender holds an effective lien on the collateral at least vis-à-vis the mezzanine borrower.

Similar to junior mortgage financing, the national rating agencies also dictate to a large extent the form and structure of mezzanine financing.¹⁵⁵ For instance, in a typical mezzanine financing, the rating agencies require that the underlying organizational documents of the mezzanine borrower only permit certain specified activities. As a corporate law matter, the mezzanine borrower may only own the direct or indirect equity in the mortgage borrower and it is typically prohibited from undertaking any other corporate or business activity.¹⁵⁶ Because of these organizational limitations, this type of entity is referred to as a “special purpose” entity (SPE).

The rating agencies often also require the underlying organizational documents of the mezzanine borrower to prohibit or significantly curtail its ability to file any type of petition for bankruptcy, insolvency, or reorganization.¹⁵⁷ These types of provisions and limitations are optimistically considered to make an entity “bankruptcy remote,” and the industry refers to such an entity as a bankruptcy

¹⁵⁴ Forte, *Mezzanine Finance*, *supra* note 14, at 441.

¹⁵⁵ Fitch, *Evaluating Additional Debt*, *supra* note 113; Moody’s, *A-B Notes*, *supra* note 113; S&P Criteria, *supra* note 99, at 18.

¹⁵⁶ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 2-3; Moody’s, *A-B Notes*, *supra* note 113, at 8-9; S&P Criteria, *supra* note 99, at 20-22.

¹⁵⁷ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 3-5; Moody’s, *A-B Notes*, *supra* note 113, at 8-9; S&P Criteria, *supra* note 99, at 20-22.

remote entity (BRE). In order to qualify as a SPE/BRE, the rating agencies also require strict limits on the type and amount of permitted additional indebtedness and require their approval of the identity of, and the review of the management, finances, and experience of, the mezzanine lender.¹⁵⁸ These limitations represent, in part, the agencies attempt to avoid the substantive consolidation of the mezzanine borrower's assets with another bankrupt but related entity.

Since the mezzanine lender's collateral is equity in another entity, the collateral is technically personal property; therefore Article 9 of the Uniform Commercial Code (UCC) applies rather than local mortgage law.¹⁵⁹ By recording a UCC-1 Financing Statement in the appropriate recording office,¹⁶⁰ the mezzanine lender can also generally ensure that its lien is effective and superior to most other third-parties'. Similar to mortgage law, once the Financing Statement describing the collateral is properly recorded, the mezzanine lender's security interest becomes perfected and is thereafter generally superior to that of subsequent lien holders, judgment lien creditors and bona fide purchasers.¹⁶¹

Mezzanine loans differ significantly from traditional loans secured by real estate where the mortgage borrower directly owns income producing real property. With a mortgage loan, the mortgage borrower grants a lien on its real property pursuant to a written instrument (typically a mortgage or in some states, a deed of trust), and thereafter the lender holds an effective mortgage lien on the collateral. In addition, since the rights and remedies of a mortgagee are inextricably linked to the mortgaged real property, the law of the state where the real property is located typically governs the enforceability of the lender's principal remedies (i.e., lender's right to obtain a receiver or foreclose the mortgage lien).¹⁶² By recording the

158 *Fitch, Evaluating Additional Debt*, *supra* note 113, at 2; *S&P Criteria*, *supra* note 99, at 18.

159 Article 9 of the UCC governs the attachment, perfection and priority of liens on most types of personal property serving as collateral, including goods, instruments, general intangibles, and equipment.

160 Pursuant to Revised Article 9 of the UCC, a mezzanine lender would file a Financing Statement with the Secretary of State of the state where the debtor is "located" to perfect its security interest in collateral consisting of equity interests. UCC § 9-501 (2000). And, a debtor is deemed located in the state where its organizational papers are filed if such debtor is required to file organizational documents (e.g., a corporation or limited liability company). UCC § 9-307 (2000). If the equity interests are certificated, however, a mezzanine lender would typically also take possession of the certificates evidencing the equity interests to ensure its first lien priority. UCC § 9-303 (2000).

161 A mortgage lien, however, is technically not "superior" to a lien held by federal or state taxing authorities. In New York, pursuant to N.Y. REAL PROP. ACTS. LAW § 1354, proceeds of a mortgage foreclosure sale can be distributed to certain tax liens held by governmental entities even if such lien is filed after the lender's mortgage.

162 Although certain contractual provisions of the mortgage (e.g., the obligation to repair and maintain insurance, specific covenants relating to the payment of the debt, financial reporting requirements, and the like) may be governed by another state's law, the remedies

mortgage in the land records where the property is located, mortgage lenders can also generally ensure that its lien is effective and superior to most other third-parties'.¹⁶³

In addition, because of the interplay between federal bankruptcy law and mortgage law, a mortgagee may typically assert a powerful arsenal of rights and remedies against both the mortgage borrower and any third party claiming any of the bankrupt debtor's assets, including any junior secured lender, unsecured creditor, or equity investor. The mortgage law of most states, for example, permits a mortgagee to appoint a receiver for the property, foreclose the mortgage and sell the real property, and eliminate many subordinate junior liens and encumbrances adversely affecting the value of the collateral.¹⁶⁴ By granting the mortgagee the power to eliminate certain junior liens and encumbrances, the mortgage foreclosure process typically enables a mortgagee to sell the property at the foreclosure sale for a higher price, thereby increasing the cash available to repay the outstanding debt.

Compared to the senior mortgage lender's right to foreclose its senior mortgage, the mezzanine lender's right to foreclose on the equity interests of the mezzanine borrower is both riskier and of somewhat limited value. Whereas a mortgagee's foreclosure rights derive from its mortgage on the borrower's real property, a mezzanine lender's remedies derive solely from its lien on personal property (i.e., the equity in the mezzanine borrower). And unlike a mortgagee's right to foreclose all junior liens and encumbrances on the underlying real property, a mezzanine lender has no rights to foreclose any other liens on the underlying real property—a mezzanine lender's rights are limited solely to foreclosing junior liens on the equity in the mezzanine borrower and not the real property. Even after a successful foreclosure of a mezzanine loan, therefore, the underlying mortgage property remains subject to the lien of the senior mortgage as well as any other liens, leases, and other encumbrances previously recorded against the mortgage property. Furthermore, the existence of a default under the mezzanine loan suggests that there is probably inadequate cash flow or some other problem with the fundamentals of the real estate venture; therefore, it is likely that there will also be new tax liens, mechanics liens, and perhaps even judgment liens recorded against the underlying

available to the lender and the mortgage foreclosure provisions will certainly be governed by the local law of the state where the mortgaged property is located.

¹⁶³ Once a mortgage is properly recorded, most states generally protect the mortgagee by ensuring that its lien is superior to most other subsequent liens and encumbrances and subsequent bona fide purchasers.

¹⁶⁴ See *supra* notes 161-162 and accompanying text.

mortgaged property. These other liens only further deteriorate the value of the mezzanine lender's collateral.

Unfortunately for many mezzanine lenders, even their right to foreclose junior liens on their own collateral—the equity in the mezzanine borrower—is often of little value. Since the mezzanine loan documents typically prohibit any other liens on the lender's collateral and because of its limited marketability, it is unlikely (except in the case of fraud or willful violation of the mezzanine loan documents) that there are any other junior liens on the equity anyway. Oftentimes, the mezzanine lender's sole remedy is to foreclose its lien on the equity and then attempt to sell the equity at a UCC foreclosure sale. But the rating agencies also restrict the mezzanine lender's ability to foreclose on its collateral without compliance with many conditions. For example, the agencies all require that the mezzanine lender obtain a "No Downgrade Letter"—written confirmation from the rating agencies that the mezzanine lender's enforcement actions will not cause a downgrade of the rating of the related CMBS issuance which is secured or contains the related senior mortgage on the underlying real property.¹⁶⁵ In addition, mezzanine lenders typically must also deliver to the rating agencies a new non-consolidation bankruptcy opinion. This opinion is typically prepared by a nationally recognized law firm and concludes that it is unlikely that the assets of the mortgage borrower will be substantively consolidated with the mezzanine borrower (or any other affiliated entities) in case of a bankruptcy.¹⁶⁶

In addition, since there is typically no active market for the purchase and sale of the equity in the mezzanine borrower and no other bidders, the mezzanine lender often has no choice other than to bid-in and "buy" the equity at the foreclosure sale. In such a case, the mezzanine lender still has not received any cash proceeds, although after the foreclosure sale, the mezzanine lender at least has direct day-to-day control of the mezzanine borrower (and, therefore, also indirect control of the mortgage borrower and the underlying real property). Only then may the mezzanine lender (in its new capacity as the indirect owner of the mortgage borrower) attempt to force a sale of the mortgaged property. But as discussed above, this right is of limited value since the underlying real property remains subject to the senior mortgage, which generally prohibits the sale of the real property and contains an extensive set of restrictive covenants and other prohibitions. The fact remains that

¹⁶⁵ See, e.g., *S&P Criteria*, *supra* note 99, at 20-22.

These agencies typically waive the requirement of obtaining a No Downgrade Letter if the mezzanine lender is a qualified, accredited or otherwise approved investor such as an institutional investor, bank or life insurance company. See Forte, *Mezzanine Finance*, *supra* note 14, at 443.

¹⁶⁶ Forte, *Mezzanine Finance*, *supra* note 14, at 443; Horowitz & Morrow, *supra* note 67, at 552-553, 570; *S&P Criteria*, *supra* note 99, at 20-22.

even after a successful foreclosure on its collateral—the equity of the mezzanine borrower—the mezzanine lender is still just an owner in the underlying mortgage borrower. As equity, the mezzanine lender's claims are structurally subordinated and junior to every other secured or unsecured creditor of the mortgage borrower.

B. Preferred Equity Financing.¹⁶⁷

In a preferred equity transaction, the financing source (the Preferred Member) typically makes an investment (generally in the form of a capital contribution) in the underlying mortgage borrower. In exchange for its investment, the financing source receives equity in the mortgage borrower, and if the senior mortgage prohibits such an investment directly in the mortgage borrower, the financing source makes an investment in a newly formed entity that indirectly owns the underlying mortgage borrower.¹⁶⁸

The Preferred Member has special rights including a preferred rate of return on its investment and accelerated repayment of its capital. The organizational documents of the investment entity (i.e., the Preferred Equity Borrower) typically provide that the Preferred Member receives its preferred return (representing the interest component) before any other member receives any cash distributions.¹⁶⁹ In addition, if the real estate venture is successful, the Preferred Member typically also has the right to receive certain cash distributions of excess cash flow. Since these distributions are usually applied to reduce the recipient's capital account, the Preferred Member typically also receives the repayment of its initial investment prior to the other equity investors.¹⁷⁰ Because of these special rights, preferred equity transactions are analytically similar to traditional loans since the preferred rate of return basically reflects interest and the accelerated repayment of the capital reflects repayment of principal.

Although these preferential payments make the Preferred Member senior to the other equity investors, the Preferred Member is still just an equity owner in the Preferred Equity Borrower. As a result, it usually remains junior to all secured or unsecured creditors. Because of this unique structure, a Preferred Member in a preferred equity financing "occupies an identical position in the capital structure and

¹⁶⁷ On preferred equity investments, in general, see Ellen M. Goodwin, *Mezzanine Finance: Senior Lender Form of Intercreditor Agreement*, COMMERCIAL REAL EST. FIN. 2002: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW (2002), available at 478 PRAC. L. INST. 997, 1017 (Westlaw); Horowitz & Morrow, *supra* note 67, at 550.

¹⁶⁸ Criteria on A/B Structure, *supra* note 16.

¹⁶⁹ And if the property manager is an affiliate of the Preferred Equity Borrower, the Preferred Member often also receives its preferred return before any fees are paid to the manager.

¹⁷⁰ Criteria on A/B Structure, *supra* note 16.

in relation to the property cash flow as a mezzanine financing” However, a Preferred Member “differs significantly because it already has an equity ownership interest and does not need to foreclose any pledge to gain an equity ownership interest . . . in the borrower.”¹⁷¹

The national rating agencies usually require that the underlying senior mortgage and/or mezzanine loan prohibit or otherwise severely restrict any distributions to equity unless there is sufficient excess cash flow from the underlying income producing property.¹⁷² And typically there is excess cash flow only after the payment of a wide variety of expenses and obligations of the mortgage borrower (e.g., (i) interest and principal under the mortgage or mezzanine loan; (ii) required cash reserves for debt service, principal prepayment, capital improvements, tenant leasing expenses, and taxes and insurance operating expenses of the mortgage property; and (iii) trade creditors, taxing authorities, judgment lien and other creditors). Consequently, the Preferred Member doesn’t ordinarily receive any cash distribution unless the enterprise is successful, there is excess cash flow, and all other expenses and debt obligations have been satisfied in full. No matter that a preferred equity transaction is substantively similar to a loan—since preferred equity is not legally structured as debt, a Preferred Member does not have the same rights as a creditor of the mortgage borrower. Given these structural realities, a Preferred Member is likely to receive its preferred rate of return and the repayment of its initial investment only if the mortgage borrower realizes its lofty economic projections, generates sufficient cash flow, and repays in full all its outstanding debt obligations.

On the other hand, if the venture fails to earn sufficient cash flow to repay the senior mortgage, it is likely that the Preferred Equity Borrower will default since there will also be insufficient funds to pay the Preferred Member its preferred return or capital. In order to maintain the fiction that preferred equity is not debt, however, the transaction documents typically refer to these “defaults” as “Change of Control Events”. And, if a Change of Control Event occurs, most preferred equity arrangements provide that day-to-day control and management of the Preferred Equity Borrower automatically and immediately shifts to the Preferred Member. This “change of control” mechanism effectively makes the Preferred Member’s remedies similar to a mezzanine lender. As discussed above, a mezzanine lender in order to enforce its rights typically would foreclose its lien on the equity interests, thereby seizing day-to-day control of the mezzanine borrower. In this way, the

¹⁷¹ Forte, *Mezzanine Finance*, *supra* note 14, at 442.

¹⁷² Fitch, *Evaluating Additional Debt*, *supra* note 113, at 4-5; S&P Criteria, *supra* note 99, at 20-22.

mezzanine lender gains indirect but effective control of the mortgage borrower and the underlying mortgaged property. Unlike the mezzanine loan, however, the Preferred Member's financing arrangement is structured as an equity investment rather than secured debt. Therefore, there is no collateral and the Preferred Member has no foreclosure rights. However, after a Change of Control Event occurs, the Preferred Member effectively controls the mortgage borrower by virtue of the contractual provisions contained in the organizational documents of the borrower.

Although the Preferred Member will effectively control the mortgage borrower after a Change of Control Event occurs, the shift in control does nothing to eliminate any of the liens, contractual obligations, mortgages, and other obligations binding upon the mortgage borrower. Similar to a mezzanine lender, therefore, the Preferred Member also takes the "collateral" (i.e., control of the mortgage borrower) subject to the senior mortgage and any other existing liens and obligations. And unlike a mortgage lender, neither the mezzanine lender nor Preferred Member may foreclose upon and thereby eliminate any of these liens or encumbrances. In addition, preferred equity investments are also subject to certain bankruptcy risks such as the possibility that a bankruptcy court would recharacterize its equity investment as debt.¹⁷³

Furthermore, many senior mortgages prohibit any change in the composition of the direct equity investors in the mortgage borrower or a material change in the parties exercising effective control over the mortgage borrower. If the Preferred Member begins to exercise control of the mortgage borrower as a result of the occurrence of a Change in Control Event, therefore, it is likely that there would also be a default under the senior mortgage. Any default under the senior mortgage or the commencement of a mortgage foreclosure action substantially reduces the value of the Preferred Member's investment in the mortgage borrower. As a result, these mortgage prohibitions often leave the mezzanine lender and Preferred Member without any effective remedy.

IV. Mezzanine Loans and Preferred Equity Financings are Mortgage Substitutes

In this Section, I argue that junior mortgages, mezzanine loans and preferred equity financings all occupy the same position in the borrower's capital structure, that mezzanine loans and preferred equity financings are mortgage substitutes, and that lender's are attempting to avoid the borrower's equity of redemption. I conclude that there are strong policy reasons to apply the traditional property law adage—

¹⁷³ Forte, *Mezzanine Finance*, *supra* note 14, at 442.

“once a mortgage, always a mortgage”—to these new financings and recharacterize mezzanine loans and preferred equity financings as junior mortgages.

As discussed in Section I above, historically, lenders and debtors often hid their true relationship behind contracts and other layers of artifice. From the first use of Glanville’s gage in England to the common law mortgage, lenders increasingly obtained stronger rights in the mortgaged land with carefully constructed contractual provisions.¹⁷⁴ Although the legal structures differed, these early financing devices were remarkably similar to each other. In each instance the lender attempted to increase its arsenal of rights and remedies, minimize borrower’s contractual or equitable protections while at the same time retaining the borrower’s real property as collateral. To accomplish this task and later to avoid the borrower’s equity of redemption, lenders structured and documented these early financing transactions to appear as something other than a mortgage.¹⁷⁵

Oftentimes, these legal structures resulted in forfeitures and gave lenders an unexpected windfall, particularly when the value of the land greatly exceeded the amount owed to the lender. It wasn’t long before common law judges attempted to avoid the harsh results inflicted by the contractual provisions of these early financing transactions. Throughout this early period, judges increasingly began to look beyond the four corners of the contract, disregarding the lender’s self-serving characterization of the transaction. The equity courts began to look at the substance of the transaction rather than the formal contractual nature of the relationship. It was clear to the judges that the substance of these transactions was simply a secured loan transaction with the borrower’s land serving as collateral for the loan. Once characterized as a mortgage, it was but a small step for the equity courts to grant these hapless borrowers the same rights and protections typically afforded to mortgagors. The most important of these rights, of course, was the equity of redemption—the right of the borrower to redeem its property upon payment of the outstanding debt due to lender at any time prior to the foreclosure of its equity of redemption.¹⁷⁶

We are now also in a new era of real estate law where lenders and borrowers structure financing transactions to resemble something other than a junior mortgage. As discussed in Section III, although mezzanine loans are secured financings, there is no direct real estate collateral. Lawyers carefully structure these financings so that the mezzanine borrower is a special purpose and bankruptcy-remote entity that

¹⁷⁴ The culmination of this trend was Littleton’s gage, where the lender actually obtained fee title to the mortgaged land with almost all the rights incident to absolute ownership, including the right to possession and collection of rents and profits. *See supra* notes 27-32 and accompanying text.

¹⁷⁵ *See supra* notes 39-43 and accompanying text.

¹⁷⁶ *See supra* notes 44-60 and accompanying text.

owns no assets other than its ownership interest in another entity.¹⁷⁷ Unlike a mortgage loan that is directly secured by land, the only collateral for a mezzanine loan is the mezzanine borrower's pledge of its ownership interest in another subsidiary entity. The value of the lender's collateral, therefore, derives solely from the mezzanine borrower's (typically indirect) ownership and control of the subsidiary that owns the underlying real property.¹⁷⁸ The underlying land, however, is also serving as collateral for a senior mortgage loan, and that mortgage loan is also included in a pool of mortgages securing the related CMBS transaction.¹⁷⁹

Looking at a property owner's family of related entities in its entirety, however, the capital structure of mezzanine financing resembles almost exactly traditional mortgage financing. With traditional mortgage financing, the capital structure (in order of payment priority) typically consists of the senior secured mortgage followed by the junior mortgage and finally by the borrower's equity. The senior mortgage loan typically represents approximately 65–75% of the value of the underlying real property, and the junior mortgage typically brings the loan-to-value ratio of the total mortgage debt to approximately 85–90%.¹⁸⁰ In the traditional senior-junior mortgage financing, the junior mortgage is in the intermediate level of the borrower's capital structure and is structurally subordinated in right of payment and lien priority to the senior mortgage, although it remains senior to the property owner's equity.¹⁸¹

Although structured differently from a junior mortgage, mezzanine financing is also the intermediate level in the property owner's capital structure. In a mezzanine loan transaction, the capital structure resembles the payment priorities of traditional senior-junior mortgage financing except that the senior secured mortgage is followed by the mezzanine loan and then the borrower's equity. As with the traditional model, the senior mortgage loan in a transaction with mezzanine

¹⁷⁷ See *supra* notes 11, 154, 156 and accompanying text.

¹⁷⁸ See *supra* notes 12, 154, 156 and accompanying text.

¹⁷⁹ See *supra* note 13 and accompanying text.

¹⁸⁰ See *supra* note 145 and accompanying text; see also Christine McGuinness, *Title Insurance for the Mezzanine Lender*, 19 N. Y. REAL EST. REP. 1, 1 (2004) ("A typical mortgage loan involves a loan amount of approximately 65% to 75% of the appraised value of a property and a first mortgage lien."); M. Anthony Carr, *Multi-Layered Loans Offer PMI Alternative*, June 1, 2001, at http://realtymtimes.com/rtpcpages/20010601_pmi.htm (last visited July 14, 2005); Sarah Mav, *Homebuying with No Money Down*, Mar. 8, 2005, at http://money.cnn.com/2005/03/07/real_estate/financing/lowdownpayment/ (last visited July 14, 2005).

¹⁸¹ See Rene Faulkner, *BFP v. Resolution Trust Corp.: Interpretations of Section 548 of the Bankruptcy Code and the Potential Effects on Mortgages and the Economy*, 17 WHITTIER L. REV. 579, 582 (1996) ("If the foreclosure sale brings more than the amount of the first mortgage debt, the junior mortgagees will have a superior claim to the surplus over that of the mortgagor. If the sale covers all the debts, the mortgagor will have a claim to the surplus.").

financing typically represents approximately 65–75% of the value of the underlying real property. The mezzanine loan usually brings the loan-to-value ratio of the total debt secured either directly or indirectly by the underlying real property to approximately 85–90%.¹⁸² Since the mezzanine loan is structurally subordinated in right of payment and lien priority to the traditional senior mortgage, but is senior to the property owner's equity interests, the mezzanine loan, just like the junior mortgage, is also in the intermediate level of the borrower's capital structure.

This analysis applies equally to preferred equity financings. Here, the market participants structure these financings to resemble a cash investment in an entity in exchange for ownership interests and a preferred return of capital.¹⁸³ The parties are not entering into a loan transaction, and there is no collateral. In these transactions, the Preferred Member is clearly equity rather than debt. However, the lender's equity interest is preferred and senior in right of payments to all other equity. Because of the unique structure, the Preferred Member's capital contribution also occupies the intermediate level in the property owner's capital structure.

In a typical preferred equity financing, the capital structure and payment priorities also resemble traditional senior-junior mortgage financing—the senior mortgage is first, followed by the Preferred Member's equity interests, and finally the property owner's equity. Once again, the senior mortgage loan in this type of financing typically represents approximately 65–75% of the value of the underlying real property. As with mezzanine and junior mortgage financing, the Preferred Member's contribution typically brings the loan-to-value ratio of the total debt and preferred equity secured either directly or indirectly by the underlying real property to approximately 85–90%.¹⁸⁴ The preferred equity contribution is structurally subordinated in right of payment and lien priority to the senior mortgage, but the Preferred Member's right to receive cash distributions and return of capital is senior to the property owner's equity in the Preferred Equity Borrower.

Since junior mortgages, mezzanine loans and preferred equity financings all occupy the same intermediate position in the capital structure of a property owner,

¹⁸² See *supra* note 180 and accompanying text; John C. Murray, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. 279, 302 (1998) (noting that mezzanine financing commonly supplies financing of up to 90% of the project's capital structure cost); Bruce Prigoff, *B-Notes Overview*, COMMERCIAL REAL EST. FIN. 2004: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW 2004 (Jan.-Feb. 2004), available at 500 PLI/REAL 271 (Westlaw) ("[for] mezzanine loans . . . the LTV reaches 85% or 90%");

¹⁸³ See *supra* notes 16, 168 and accompanying text.

¹⁸⁴ David E Watkins, David J. Hartzell & Dean Egerter, *Commercial Real Estate Mezzanine Finance: Market Opportunities*, REAL ESTATE ISSUES, Sept. 22, 2003 ("Preferred equity and gap equity are common names for equity-type financings that bring the capital structure above 85% LTV.")

should the law treat all three types of financings similarly? Is there any public policy purpose or other acceptable justification to treat these three types of financings differently? Are lenders in effect avoiding the legal protections a borrower would ordinarily have under a junior mortgage such as the borrower's equity of redemption in order to minimize the hazards and delay of mortgage foreclosures? Simply put, should the law treat mezzanine financings and preferred equity transactions as simply another type of mortgage substitute under traditional property theory?

To date, these questions remain unanswered for the simple reason that courts have not yet had an opportunity to consider them. There have been no reported cases involving mezzanine loans or preferred equity transactions where any of the parties have attempted to enforce their contractual rights and remedies.¹⁸⁵ In fact, in a recent conference on the real estate capital markets sponsored by New York University's Real Estate Institute, many panel members confirmed that there have been few if any enforcement actions by mezzanine lenders or Preferred Members. For the few loans that have gone into default, lenders have typically chosen private loan restructurings and workouts.¹⁸⁶ However, it is only a question of time before courts will address a similar set of issues that common law courts in England addressed—should these non-traditional financings be treated as mortgage substitutes?

Initially, the equity courts' development and enforcement of a borrower's equity of redemption signaled their refusal to enforce the harsh forfeiture provisions contained in the transaction documents evidencing all sorts of mortgage substitutes. As discussed in Section I, the equity courts looked beyond the four-corners of the contract documents and developed a set of equitable principles that reflected the true underlying nature of the debtor-creditor relationship. Although the decisions of the equity courts eroded the then existing "freedom of contract" rules, the courts at the same time developed a new and separate body of mortgage law.¹⁸⁷ Consequently, these courts did not focus solely on the formal structure or contract documents evidencing the secured loan, but rather they examined the true substance of the debt transaction.

To a large extent, lenders and other market participants now attempt to treat mezzanine loans and preferred equity investments as the functional equivalent of

¹⁸⁵ In a Lexis and Westlaw search performed on July 12, 2005, there were only three cases. None of the three directly involved the lender's attempt to enforce its remedies.

¹⁸⁶ Hugh Frater, Managing Director, Blackrock, Inc., *Rising Tide of Interest Rates and the Global Real Estate Markets*, NYU'S REAL EST. INST.'S 37TH ANNUAL CONFERENCE ON CAPITAL MKTS. IN REAL EST. (Dec. 8, 2004) (Notes on file with author).

¹⁸⁷ See *supra* notes 57-66 and accompanying text.

junior mortgages secured by real property.¹⁸⁸ The legal structure of these transactions, however, suggests something entirely different. In a mezzanine loan, for instance, the lender's sole collateral is typically a pledge of the borrower's equity in another entity.¹⁸⁹ From a legal and structural viewpoint, a mezzanine loan is no different than any loan secured by stock or other types of equity. For example, as with any loan secured by stock, Article 9 of the UCC governs the creation, perfection, and priority of liens and the procedures relating to a lender's rights, remedies and other enforcement actions.¹⁹⁰

However, a mezzanine loan is fundamentally different from other secured loans where the collateral consists of equity in a publicly traded company or even a private company that operates an ongoing business or owns actual assets such as inventory, equipment or receivables. In part due to rating agency requirements, the mezzanine borrower is almost always a special purpose and bankruptcy-remote entity and owns absolutely no assets other than equity in another entity.¹⁹¹ All of the value of the pledged equity serving as collateral for the mezzanine loan derives solely (albeit indirectly) from the underlying real property. There is simply nothing else of value in the entire family of entities other than the rental income generated by the underlying real property. That same property, however, also simultaneously serves as collateral for a senior mortgage loan, and that same mortgage loan is also likely to be included in a pool of mortgages for a CMBS transaction.¹⁹²

Similarly, a preferred financing transaction is also different from most other types of equity investments. Although investors often structure equity investments to provide different classes of investors varying rights, preferences and payment priorities, with a preferred equity financing the Preferred Member is fundamentally acting like a lender, and the market participants functionally treat the transaction as a loan. As with mezzanine loans, the rating agencies require, and parties typically ensure, that the Preferred Equity Borrower be a special purpose and bankruptcy-remote entity and that it owns no assets other than the equity in the underlying mortgage borrower.¹⁹³ Once again, all of the intrinsic value of the Preferred Equity Borrower derives solely from its indirect ownership interest in the underlying real

¹⁸⁸ Horowitz & Morrow, *supra* note 67, at 544; *see also supra* notes 179, 181 and accompanying text.

¹⁸⁹ *See supra* notes 11-12, 154 and accompanying text.

¹⁹⁰ *See supra* notes 159-160 and accompanying text.

¹⁹¹; Fitch, *Evaluating Additional Debt*, *supra* note 113, at 2; Moody's, *A-B Notes*, *supra* note 113, at 9, n.5; S&P Criteria, *supra* note 99, at 17, 89.

¹⁹² James D. Prendergast & Keith Pearson, *How To Perfect Equity Collateral Under Article 8*, PRAC. REAL EST. LAW. (Nov. 2004) at 34, available at 20 NO. 6 PRACREL 33 (Westlaw).

¹⁹³ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 2-3; Moody's, *A-B Notes*, *supra* note 113, at 9; S&P Criteria, *supra* note 99, at 17, 89

property; that same property simultaneously serves as collateral for a senior mortgage. As with the mezzanine loan, that same senior mortgage is likely to be included in a CMBS transaction.¹⁹⁴

There is a growing tension in these transactions, however. On one hand, the market participants structure and document these financings in an attempt to ensure that the law preserves and recognizes the fiction that mezzanine loans and preferred equity financings are legally distinct from junior mortgages. On the other hand, that same parcel of real property simultaneously serves as collateral for the senior mortgage and these other non-traditional financings, and mezzanine loans and preferred equity financings have many of the same financial and economic characteristics of traditional junior mortgages. At present, it is unclear whether courts will respect the crafty legal structures underlying mezzanine loans and preferred equity financings or treat them as mortgage substitutes. As Joseph Forte has observed,

as defaults rise and lenders attempt to enforce rights under senior mortgages and mezzanine financing arrangements, the courts will review the structure and intercreditor issues and provide guidance—good and bad—for future transactions. While negotiations between borrowers, mortgage lenders and mezzanine lenders are hotly contested, these structures are only truly vetted and stressed in a contested litigation scenario. Only then will we discover whether the documents and the contemplated structure will be upheld and enforced as drafted.¹⁹⁵

It is equally unclear whether courts will enforce the rights, remedies and enforcement provisions of mezzanine loans and preferred equity financings.

The national rating agencies would prefer that courts adopt a strict contract theory and simply enforce the contractual provisions of the mezzanine loans and preferred equity transactions. This explains in part why all four national rating agencies have such stringent underwriting guidelines for mortgage loans included in rated CMBS transactions and why they so clearly articulate the legal structures and contractual provisions necessary for rated CMBS transactions. As discussed in Section II, rating agencies believe (perhaps correctly so) that the rights and remedies of junior lenders and mortgage borrowers under various state mortgage and foreclosure laws and under federal bankruptcy law significantly increase the risk profile and therefore adversely affect the credit rating of CMBS securities.¹⁹⁶ In response to this perception, rating agencies work to ensure that CMBS and non-

¹⁹⁴ See *supra* note 192 and accompanying text.

¹⁹⁵ Forte, *Mezzanine Finance*, *supra* note 14, at 445.

¹⁹⁶ See *supra* notes 113-28 and accompanying text.

traditional financings limit a property owner's and any other affiliated entity's ability to incur junior mortgage debt or any other type of additional debt.

These transaction documents raise certain fundamental issues and expose the simmering tension between contract and property law.¹⁹⁷ Under common principles of contract law, courts have traditionally enforced parties' contractual agreements—after all, much of our law is based on the belief that parties should be free to contract and structure their transactions as they desire and the law ought to enforce those agreements accordingly. But, property law has long recognized that freedom to contract is not absolute, and that at times certain equitable and property law concepts outweigh the right to contract.

Presently, the tension between the contract and property theory approach is bubbling to the surface in the world of the real estate debt and capital markets. Here we have market participants, in particular, senior mortgage lenders and the national rating agencies, championing the freedom to contract and structure their transactions as they see fit. They argue for courts to enforce strictly and literally the contractual provisions contained in the documentation for mezzanine loans and preferred equity financings. But one cannot ignore basic principles of equity and property law in transactions that are fundamentally related to, and inextricably tied to, real property. As the oft-quoted adage goes: once a mortgage, always a mortgage. The market participants cannot make what is in essence junior mortgage financing something other than it is by simply labeling and structuring it as mezzanine debt and preferred equity.¹⁹⁸

What factors should be relevant in determining whether a court ought to enforce the contractual provisions of the non-traditional financing documents? I believe that a court ought to consider a range of factors and questions in determining whether to (re)characterize these non-traditional financings as junior mortgages as the courts do with traditional mortgage substitutes. First, what is the basic substantive relationship between the contract parties? Is the mezzanine lender and preferred equity investor substantively acting in the same capacity as a junior mortgagee? Is the mezzanine loan and preferred equity in the intermediate level of

¹⁹⁷ Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389 (1993); Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L. REV. 405 (2002); Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 CORNELL L. REV. 288, 341 (1987); see also *supra* note 65.

¹⁹⁸ Tracht, *supra* note 45, at 643 ("no words of Scrivener nor any invention of Counsel can make that which was intended as a mortgage to work as an absolute assurance") (quoting LORD NOTTINGHAM'S MANUAL OF CHANCERY PRACTICE AND PROLEGOMENA OF CHANCERY AND EQUITY 280 (D. Yale ed., 1975)).

the property owner's capital structure? If so, there is an equitable argument that the law ought to treat similarly situated parties in the same manner.

Second, what is the loan-to-value ratio of the various financings, and is there any collateral for the mezzanine loan or preferred equity financing other than the underlying real property? To the extent that the loan-to-value ratio begins to approach 85-90% of the value of the property and the only collateral consists entirely of the underlying real property, these non-traditional financings once again begin to look like a junior mortgage. After all, in traditional mortgage financing, both senior and junior mortgagees rely on the cash flow and value of the underlying land. In addition, both senior and junior mortgagees have separate and distinct rights in the same parcel of real property. Similarly, the economic and legal reality is that with these new financing techniques, both the senior mortgagee, on the one hand, and the mezzanine lender and preferred equity member, on the other hand, also have separate and distinct rights in the same real property.

Third, is the mezzanine loan or preferred equity financing being made simultaneously with, or otherwise in contemplation of, a senior mortgage loan? Are the parties attempting to make the related mortgage loan "securitizable" so that it may be included in a CMBS transaction? If so, because of the enormous power of the national rating agencies and their near monopolistic control of the market, it is likely that both the property owner and non-traditional lender have significantly diminished bargaining power.

Fourth, is it the intent of the parties that the underlying real property serve as the principal collateral for the mezzanine lender and preferred equity investor? Are these non-traditional lenders attempting to obtain the same package of rights that a typical junior mortgagee would have? As with traditional mortgage substitutes, the law ought to seek to protect the parties' expectations and intent in entering into these transactions in the first place.

Furthermore, a court ought to consider the basic equities involved and whether the underlying property owner would be unduly injured if a court respected the legal structure and enforced the contractual provisions of the mezzanine loan or preferred equity transaction. For example, as discussed in Section III, because the lender's enforcement of its rights and remedies under a mezzanine loan is typically governed entirely by Article 9 of the UCC, the basic protections afforded under state mortgage law simply do not apply to the borrower.¹⁹⁹ The most important of these rights is the borrower's common law equity of redemption. While it is true that the UCC includes its own limited version of the equity of redemption and there are other procedural safeguards applicable to UCC foreclosures, as a

¹⁹⁹ See *supra* notes 158-60 and accompanying text.

practical matter many of the UCC safeguards do not actually protect the borrower. Because of the unique nature of the collateral in mezzanine loan transactions, it is unlikely that there will be any real market or third-party purchaser at a UCC foreclosure sale anyway. The most likely bidder will be the mezzanine lender, resulting in the mezzanine lender owning all of the borrower's ownership interests in the property after the foreclosure sale.²⁰⁰

Based on an evaluation of these factors, a court could easily conclude that mezzanine loans and preferred equity financings remain substantively indistinguishable from junior mortgage financing. Despite the parties' attempt to put in place formalistic and largely artificial legal structures, these transactions remain in essence secured real estate financings. Simply put, once a mortgage, always a mortgage. If land and real property is to remain an integral part of our financing system, as I believe it should and will, then the law ought to treat mezzanine loans, preferred equity financings and junior mortgages similarly (at least vis-à-vis the senior lender and mortgage borrower.) This approach is also consistent with the historical approach that courts have taken with real estate financings.

Treating mezzanine loans, preferred equity financings and junior mortgages similarly has several benefits—it reduces transaction costs (at least prospectively), certain other hazards, and negative externalities, and it helps facilitate renegotiations, workouts and negotiated settlements if a default occurs. At the same time it gives the law greater legitimacy since the law would be treating similar transactions and all parties that are in substantively in the same position similarly.

After all, the rule of law requires that similar transactions (no matter how labeled) be treated similarly.

By characterizing mezzanine loans and preferred equity financings as mortgage substitutes it also reduces transaction costs since presently market participants spend an enormous amount of time and expense to document and structure non-traditional financings in an attempt to ensure that courts will respect these legal fictions and artificial structures. As previously discussed, the rating agencies require that mezzanine borrowers and Preferred Equity Borrowers be structured as special purpose-bankruptcy remote entities.²⁰¹ There are myriad other requirements, however. The rating agencies also require that legal counsel deliver substantive non-consolidation opinions. These reasoned opinions of law attempt to

²⁰⁰ UCC § 9-615(f) provides that if the proceeds are significantly below what would have been obtained had the sale been made to an unrelated third party, the deficiency is calculated not on the basis of what was actually received, but on what would have been received if the sale had been made to an independent third party. Barkley Clarke, *Revised Article 9 Of The UCC: Scope, Perfection, Priorities, And Default*, N.C. BANKING INST., APRIL 2000, at 177, available at 4 N.C. BANKING INST. 129, 177 (Westlaw).

²⁰¹ See *supra* note 193 and accompanying text.

provide some comfort to the market participants and, most important, to the rating agencies, that a bankruptcy judge would not order the substantive consolidation of the assets of the mortgage borrower, mezzanine borrower, or Preferred Equity Borrower with the assets of any other affiliated bankrupt debtor.²⁰² Since substantive consolidation is an equitable doctrine, there is ample conflicting case law on the matter, all of which must be summarized and explained by legal counsel. Furthermore, senior mortgagees typically require mezzanine borrowers and Preferred Equity Borrowers to enter into very complicated and overly restrictive subordination and inter-creditor agreements, lock-box and cash management agreements, and other similar transaction documents.²⁰³ These documents and legal structures are time consuming and expensive to create. Although hard to quantify, these attempts to deal with the uncertainties of the present legal regime necessarily increases transaction costs for real estate financings.

Similarly, treating mezzanine loans and preferred equity financings as mortgage substitutes also reduces certain other hazards found in the existing marketplace. Presently, the legal opinions of large law firms provide a false sense of security to the lenders. Mezzanine lenders and preferred equity investors are perhaps unrealistically confident that their transaction documents are actually enforceable, that a bankruptcy court would not order the substantive consolidation of borrower's assets with another bankrupt debtor or void certain transfers as a fraudulent preference, and that the lenders and investors can effectively and quickly enforce their rights and remedies under the transaction documents and obtain control of the underlying property. Despite the best efforts of the law firms documenting these transactions, however, these risks continue. In addition, there is the difficulty and cost associated with enforcing a pledge of equity in a closely held company under the UCC, as well as bankruptcy-related risks such as substantive consolidation, an automatic stay interfering with lenders' enforcement of "change of control" provisions in preferred equity transactions, and initial transfers into mezzanine borrower and Preferred Equity Borrower being set aside as preferences.

By failing to take into account certain inherent risks associated with secured subordinated financing, mezzanine lenders and preferred equity investors invariably engage in riskier lending practices either by over-extending credit or under-pricing loans. These practices all lead to unnecessary risk taking by all of the market participants. Similarly, there is likely a mismatch between the ratings of CMBS

²⁰² See Horowitz & Morrow, *supra* note 67; see also Fitch, *Evaluating Additional Debt*, *supra* note 113, at 3; S&P Criteria, *supra* note 99, at 20-21, 96-97; Murray, *supra* note 182, at 303.

²⁰³ Fitch, *Evaluating Additional Debt*, *supra* note 113, at 2-3; Moody's, *A-B Notes*, *supra* note 113, at 9; S&P Criteria, *supra* note 99, at 20-21, 96-97.

securities and its market pricing since the ratings are based on the rating agencies' erroneous belief that these artificial structures will withstand judicial challenge. There would be much more certainty and transparency in the marketplace if the law not only treated these non-traditional financings as junior mortgages, but also if the market priced them as junior mortgages.

The unnecessary risk taking also results in certain negative externalities that are inadequately borne by the market participants and may have potentially deleterious effects on our economy. Although increased capital available for real estate investments is a social good, it can also be argued that the explosion of capital available for property owners might actually cause greater harm. If we posit that mezzanine lenders and preferred equity investors extend too much credit at too low a price, then, as most economists would argue, property owners will make increasingly riskier bets using other's capital. It is only a question of time before there is a downturn in the seemingly limitless growth of the real estate market and these non-traditional financings begin to default. These defaults undoubtedly will cause a ripple effect throughout our economy, in part, due to the interconnectedness between CMBS and the secondary mortgage market, mezzanine loans, preferred equity financings, and other non-traditional real estate financings. And the various social costs will be borne by consumers and the public rather than solely by the market participants themselves.

Furthermore, as these non-traditional financings begin to default, it will be increasingly difficult for the parties privately to restructure and work-out these loans. As Poindexter observed in her article examining the CMBS marketplace²⁰⁴, traditional real estate lending was bi-lateral involving simply the mortgage lender and property owner. Since the advent of CMBS, however, real estate finance has become multilateral. Now, in addition to the mortgage lender and property owner, there are many interrelated participants: CMBS investors, trustee, lock-box bank, special and master-servicers, and rating agencies. Not surprisingly, Poindexter concludes that because of all the various parties involved it will be increasingly difficult for a mortgage lender and property owner to fashion a private bi-lateral response to a loan default.²⁰⁵ The increasingly common use of mezzanine loans and preferred equity financings will only make it even more difficult to achieve a private consensual workout.²⁰⁶

Similarly, Poindexter observes that because the many participants in CMBS transactions all have increasingly competing interests, multi-lateral attempts to restructure a loan in default are likely to fail. In CMBS transactions, the objectives of

²⁰⁴ Poindexter, *supra* note 84.

²⁰⁵ Poindexter, *supra* note 84, at 535.

²⁰⁶ Poindexter, *supra* note 84, at 548-63.

bondholders shift from debt to equity as subordination levels increase. Whereas a holder of debt seeks repayment of debt, holders of equity typically seek preservation of value of company.²⁰⁷ Consequently, she argues that CMBS causes creditors' rights to be more "attenuated from the investors' equity stake."²⁰⁸ But, with mezzanine loans and preferred equity financing, Poindexter's observation is even more striking since both preferred equity investors are equity and mezzanine lenders' only collateral is also equity. The interests of mezzanine lenders, preferred equity investors, and holders of deeply subordinated CMBS securities are unlikely to align themselves with the senior mortgage lender and the holders of the higher rated CMBS securities. As a result, it will be less likely that parties can achieve a private consensus on a loan workout. However, by applying the equity of redemption to mezzanine loans and preferred equity financings and characterizing them as mortgage substitutes, many have argued that contract parties may be more likely to engage in renegotiations, workouts and other voluntary settlements out of court.²⁰⁹

In the present legal environment where there are no clear rules, there will undoubtedly be litigation as parties fight for their competing share of the collateral and residual value of the underlying property owner's assets. Faced with this litigation and few if any rules to adjudicate these disputes, I believe that courts ought to apply the established body of law relating to mortgage substitutes to these new non-traditional financing techniques. By so doing, at least there would be some countervailing force to the trend towards even greater stratification of competing claimants to the underlying collateral.

I also believe that if the courts were to enforce the contractual provisions and remedies contained in mezzanine financings and preferred equity investments that it would lead to yet other negative externalities, such as undermining basic principles of corporate governance and fiduciary duty while further eroding the basic legal differences between debt and equity. If a court were to permit a mezzanine lender to easily enforce its lien on the equity of its borrower or a Preferred Member to seize effective control over the entity, then investors could not truly champion the rights of other stakeholders in the underlying mortgage borrower. There is an essential conflict here that only worsens if mezzanine lenders and Preferred Members are permitted to take effective control of the underlying mortgage borrowers & preferred equity investors. Nowhere are the interests of the initial equity investors represented. Unlike in a bankruptcy there is no judicial supervision of the exercise of these rights. I believe that in a world of broad public suspicion of corporate

²⁰⁷ Poindexter, *supra* note 84, at 554.

²⁰⁸ Poindexter, *supra* note 84, at 533.

²⁰⁹ Tracht, *supra* note 53, at 630-636.

governance in the wake of Enron and WorldCom that enforcing this artificial distinction between debt and equity would only serve to further erode public confidence in basic corporate governance. By treating mezzanine loans and preferred equity for what they are, courts would increase transparency and public confidence in corporate governance. We should not let market participants pervert corporate governance under the guise of freedom to contract.

V. Conclusion

Although traditional mortgage lending has served the financing needs of property owners for centuries, recently there has been a surge in non-traditional financing techniques. At first, mortgage financings helped fuel the development of the secondary mortgage market and commercial mortgage backed securitizations. With the meteoric growth of the CMBS market, the power and significance of national rating agencies also began to grow. As the rating agencies became more involved with real estate finance, however, they inadvertently caused the decline of traditional junior mortgages and created the dramatic expansion of mezzanine financings and preferred equity investments.

Partly in response to the rating agencies, but also in an attempt to undercut the rights and remedies of borrowers, legal practitioners have drafted complicated legal structures and documents for mezzanine loans and preferred equity financings. These transactions raise certain fundamental issues and expose the simmering tension between contract and property law. Since junior mortgages, mezzanine loans and preferred equity financings all occupy the same intermediate position in the capital structure of a property owner, there is no acceptable justification to treat these financings differently. Lenders are simply attempting to avoid the borrower's equity of redemption. Based on the centuries-old property law adage—"once a mortgage, always a mortgage"—mezzanine loans and preferred equity financings are in effect mortgage substitutes, and the law should apply traditional property theory to these new financing techniques and treat them as mortgages.